BANKRUPTCY POLICY, LEGAL HERITAGE, AND FINANCIAL DEVELOPMENT: AN AGENDA FOR FURTHER RESEARCH

Ziad Raymond Azar[*]

INTRODUCTION 382
I. THE THEORETICAL DEBATE 382
A. *Proceduralists versus Traditionalists* 383
1. *The Proceduralists* 383
2. *Traditionalists* 386
3. *Recapitulation* 387
B. *Auction Theory* 388
1. *Auction Bankruptcy* 389
2. *Partial Auction Bankruptcy* 390
3. *Option Bankruptcy* 392
4. *Critique of Auction and Market Theories* 394
C. *Contractual Bankruptcy* 396
1. *A Menu Approach* 396
2. *Waiver Bankruptcy and Chameleon Equity* 397
3. *A Skeptical View* 398
4. *Bribe for Contract Bankruptcy and Critique of the Theory* 399
D. *The End of Bankruptcy?* 401
E. *Reversal: APR Violation is Efficient and Conforms to the Creditor's Bargain* 403
1. *The Notion of Common Disasters* 404
2. *Skeptical Critic* 405
F. *Economists Join the Debate: APR Violation is Not Inconsistent with Efficiency* 406
1. *The Case for Management Bias in Bankruptcy Reorganization* 406

---

[*] Advanced Legal Studies (University of Paris I, Pantheon-Sorbonne); M.A. in Economics (New York University); LL.M. (Georgetown University); S.J.D. candidate (Harvard Law School). Associate (White & Case LL.P. New York). Without implicating them in my mistakes, I wish to thank Elizabeth Warren, Mark Roe, George Triantis, Holger Spamann and Rita Ramalho for their extensive comments and encouragement.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

2. *Contract Enforcement as Determinant of the Bankruptcy System* 407
3. *A Near Sighted Justice can be Tantamount to Efficient Bankruptcy Regime* 408

II. EMPIRICAL STUDIES: THE COST OF BANKRUPTCY 408
A. *Bankruptcy Proceedings are Not Costly* 410
B. *Auction Bankruptcy is Not More Efficient* 414
1. *Swedish Auction Bankruptcies* 414
2. *Chapter 7 Costs versus Chapter 11 Costs* 416
C. *Low Confirmation Rates and Lower Consummation Rate: A Sign of Inefficiency?* 418
1. *Confirmation Rates in the United States* 418
2. *What is the Efficient Confirmation Threshold?* 423
D. *APR Violations are More Common Under Chapter 11: Is Chapter 11 Exacerbating the Problem of Forum-Shopping?* 424
1. *Comparing Data from Before and After 1978* 425
2. *Reinterpreting the Data: Warren's Reply* 426
E. *Contract Bankruptcy would be Re-Distributional and Costly* 427

III. EMPIRICAL CROSS-COUNTRY STUDIES: BANKRUPTCY AND THE DETERMINANTS OF FINANCIAL DEVELOPMENT 428
A. *The LLSV Creditors' Right Index, Financial Development, and Legal Heritage* 429
1. *The Model and Findings* 430
2. *Critique: Ambiguity and Under-Specification in the Definition of Variable* 432
B. *LLSV Creditors' Right Index and the Determinants of Private Credit* 434
1. *The Findings* 435
2. *Critique: Ambiguity and Under-Specification in the Definition of Variable* 436
C. *Collateral Law More Important Than Bankruptcy Law?* 436
1. *The Model and the Findings* 436
2. *Critique: The LLSV Creditors' Right Index is Not a Bankruptcy Index* 437
D. *Debt Enforcement Around the World* 438
1. *The Model and the Findings* 438
2. *Critique: The Paper is Not Normative and Fails to Give Guidance for Reforming Collective Procedures* 445

IV. ONE SIZE FITS ALL? THE LEGAL ORIGIN DEBATE 448

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

A. *Common Law Superior to Civil Law* 449
1. *The Judicial Independence Channel* 449
2. *The Adaptability Channel* 450
3. *A Case Study: Common Law's Flexibility, Self-Regulation and Liquid Capital Market* 452
4. *Which Channel is More Important?* 453
B. *Are There Other Factors That Better Explain Financial Development?* 454
1. *Endowment Theory* 456
2. *The Transplant Effect* 457
3. *Incumbents and Resistance to Financial Development* 458
4. *Social Democracies' Anti-Market Ideology* 460
C. *Legal Origins, Financial Development, and Bankruptcy Policy* 461
1. *Multiple Optima* 461
2. *The Crucial Role of Information* 462
3. *Investors' Reaction to Known Rules* 463
4. *Implications: Fatalism and One Size Fits All vs. Functional Equivalence and Multiple Optima* 465
CONCLUSION: AGENDA FOR FURTHER RESEARCH 466

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

INTRODUCTION

What does corporate bankruptcy law aim to achieve and how should it achieve its aim? This article will review and analyze the theoretical debates and existing empirical evidence that aspire to answer these two questions. This article evaluates what various country-specific and cross-country empirical studies have and have not shown. By highlighting the findings and methodological limitations of these studies, this article proposes a research agenda which will provide a decisive answer to the debate on what are, or should be, the goals and means of bankruptcy law.

Five indicators determine whether a particular bankruptcy regime is or is not optimal. The resolution of financial distress should: (1) be equitable; (2) be prompt; (3) be cheap; (4) maximize creditors' recovery; and (5) promote growth through its effects on the availability and the cost of capital. Part I will review the theoretical and conceptual debate with respect to what should be the goals and means of corporate bankruptcy. Part II will review empirical evidence on the time, cost, and recovery rate of creditors that different bankruptcy policies yield in order to identify which bankruptcy rules bring about the best results. Part III will review cross-country empirical evidence on the role bankruptcy law plays in determining the supply of credit in order to determine which bankruptcy rule better promotes financial development. Finally, Part IV will review the possible avenues through which legal heritage and other institutional differences influence financial progress. Such influences and avenues are important to uncover for they affect what bankruptcy rules are the best fit for jurisdictions with similar institutions. This article will conclude with an agenda for further research.

I. THE THEORETICAL DEBATE

What does corporate bankruptcy law aim to achieve and how should it achieve its aim? For decades, "traditionalists" and "proceduralists," the two mainstream schools of thought in the field, have had differing answers to these two questions. To proceduralists, bankruptcy deals exclusively with creditor distribution questions.[1] Bankruptcy's ultimate goal is maximizing creditor recovery rate while scrupulously preserving the absolute priority rule. In

[1] *See* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

contrast, traditionalists believe that substantive value choices inherent to bankruptcy take into account the interests of weaker or non-adjusting economic parties, such as employees, tort victims, or other stakeholders with no formal legal rights.[2] Consideration of these parties mandates different distributional objectives, such as not strictly abiding to the absolute priority rule ("APR").

Other schools of thought have further expanded proceduralist philosophy. The proponents of auction bankruptcy argue that the market, through auctions, would implement proceduralist goals more effectively than judges and bankruptcy bargaining. Contractualists believe that the freedom of contract doctrine should be extended to bankruptcy. Investors are better at determining the most efficient insolvency regime to govern their own transactions.[3] Here, preserving absolute priority facilitates the applicability of the investors' bargain. Some scholars argue that the increased reliance by investors on auctions and on contracts where creditors allocate among themselves the control of their failing debtor announces the "End of Bankruptcy."[4] While proceduralists attempt to monopolize "efficiency" arguments as support for their view of bankruptcy, many law and economics scholars justify bankruptcy's redistributional impulses using efficiency grounds.

A. *Proceduralists versus. Traditionalists*

The proceduralist and traditionalist approaches are the two mainstream schools of thought that dominate the bankruptcy debate. Most other theories are derived from one of these two theoretical approaches.

1. *The Proceduralists*

Before Thomas Jackson's contribution to bankruptcy scholarship, many believed that bankruptcy law's primary aim was to relieve overburdened debtors. Professor Jackson realigned bankruptcy's goals with what he claims was always bankruptcy's historical and actual aim: to deal with creditor-distribution questions and to solve procedural collective problems.[5] In the

---

[2] *See* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1 (1994).

[3] *See* Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541 (1993).

[4] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002).

[5] Jackson, *supra* note 1, at 857.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

absence of bankruptcy, Jackson defined three costs creditors incur in seeking to recuperate their loans from a failed debtor. The first is a "strategic cost."[6] Outside of bankruptcy law, recuperation of one's loan is a first-come first-served exercise. The creditor who moves first takes all of the debtor's assets and leaves nothing for other creditors of equal rank and equal rights. Facing such uncertain returns, creditors will incur larger costs by running after the debtor and precipitating its failure. Second, the going concern value of otherwise viable debtors is lost in disorderly liquidations because they bring lower overall recovery rates for all claimants.[7] Finally, the duplication of inquiry and collection costs that every enforcing creditor endures increases total administrative costs and further erodes overall returns to creditors.[8]

In Professor Jackson's creditors' bargain theory, it is in the creditors' best interest to agree *ex ante* on binding collective procedural rules that would address these inefficiencies.[9] By adopting the principle of "equality is equity,"[10] a collective bankruptcy procedure lowers strategic costs. Under the "equality is equity" principle, participants share equally, based on their rank and priority rights, regardless of when each started its enforcement action. This, in turn, deters creditors' suboptimal prisoner's dilemma[11] behavior and encourages participants to choose at the outset the procedures that will best maximize the debtor's overall value. Moreover, the collective procedure saves on administrative costs by replacing multiple redundant enforcement actions with one enforcement action. This arrangement mainly benefits unsecured creditors. Therefore, secured creditors receive privileged treatment in order to induce their subscription to the bargain.[12]

Creditors that deal with the debtor change continuously over time. Consequently, the creditors' bargain is "hypothetical;" it is a bargain that rational creditors would have reached *ex ante* to orderly divide the debtor's assets upon bankruptcy.[13] Overwhelming transaction costs make the hypothetical bargain impossible to materialize in practice. Therefore, federal

---

[6] *Id.* at 861–62.
[7] *Id.* at 864–65.
[8] *Id.* at 866.
[9] *Id.* at 866.
[10] *Id.* at 859.
[11] "A logic problem . . . often used by law and economics scholars to illustrate the effect of cooperative behavior." *Black's Law Dictionary* 1233 (8th ed. 2004).
[12] Jackson, *supra* note 1, at 868–69.
[13] *Id.* at 866–67.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

mandatory bankruptcy law should replicate the terms of such a hypothetical bargain.[14]

According to Jackson's philosophy, the collective nature of the procedure determines how federal law should govern bankruptcies. Jackson instructs that bankruptcy law should be exclusively procedural aiming only to solve the collective problem created by the presence of multiple claimants. Specifically, bankruptcy law should not redistribute wealth or expropriate non-bankruptcy entitlements beyond collective imperatives.[15] As Jackson puts it, "bankruptcy functions best when it acts in a mode that is almost entirely derivative."[16] Bankruptcy law should always mirror the relative value of substantive entitlements of the non-bankruptcy world.[17] Otherwise, debtors can abuse the rights of their creditors by shopping between two legal regimes with different legal entitlements. Debtors would seek bankruptcy protection to avoid contractual obligations that are not beneficial to them in hindsight. In order to protect themselves from the risk of forum shopping, creditors would lend less or would increase the cost of capital.[18]

Because Professor Jackson and those who share his views stress the procedural nature of bankruptcy, they are known as "proceduralists."[19] Proceduralists argue that bankruptcy law should scrupulously respect the APR to avoid the inefficiencies of forum-shopping. For example, since secured creditors have absolute priority over the proceeds that are derived from the sale of their collateral outside bankruptcy, they should also have absolute priority over these proceeds in bankruptcy. To proceduralists, arguments about equity and fairness, such as protecting the wages of economically weak employees or guaranteeing a minimum right of compensation for non-adjusting and non-consensual tort creditors, have no place in bankruptcy unless these arguments are given effect outside of bankruptcy. Ideally, a procedural bankruptcy regime would also compensate secured creditors for the time value of their money and for the lost opportunities they gave up because of their inability to

[14] *Id.*

[15] Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. LEGAL STUD. 73, 114 (1985).

[16] *Id.*

[17] *Id.*

[18] *Id.* at 75.

[19] *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 578 (1998).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

enforce their rights under bankruptcy's automatic stay.[20] Indeed, outside of bankruptcy, a secured creditor could have foreclosed on its loan and invested the proceeds in a higher yielding investment. To not compensate secured creditors for lost opportunities is redistributional and, consequently, inefficient.[21]

2. *Traditionalists*

"Traditionalists" take the opposite stance.[22] According to Professor Elizabeth Warren, law and economics scholars are attracted to efficiency arguments because they shield policymakers from addressing moral theories and normative choices when studying the redistributive questions associated with times of financial distress.[23] However, when dealing with redistributive issues it is necessary and inherent to bankruptcy policy to define moral choices. From the traditionalist perspective, bankruptcy is not merely "procedural" or "derivative" in nature; to the contrary, it also reflects a "*deliberate decision to pursue different distributional objectives from those that the de facto scheme of general collection law embodies*."[24] Under bankruptcy law, the principle of "equity is equality" has replaced the principle of "first-come, first-served." However, there are instances when the law deviates from the equity principles explicitly recognizing the redistributive goals.[25] "Equality—and deliberate deviations from equality—stand at the center of bankruptcy policy."[26] According to Professor Warren, bankruptcy law is inclusive and takes into account, although indirectly and derivatively, the interests of other parties like employees and communities that do not hold formal legal rights.[27] It does so by postponing immediate liquidation and by giving distressed businesses another chance to restructure and to survive.[28]

---

[20] *See* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 117 (1984).

[21] *Id.* at 125.

[22] *See* Baird, *supra* note 19, at 577–80 (describing differences between traditionalists and proceduralists).

[23] Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 340 (1993) (citing Duncan Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387 (1981)).

[24] *Id.* at 353 (emphasis added).

[25] *Id.*

[26] *Id.*

[27] *Id.* at 354–55.

[28] *Id.* at 355–56.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Relying on the inclusive nature of bankruptcy law, Professor Korobkin offers an alternative contractarian method called the "bankruptcy choice model."[29] Since bankruptcy potentially affects society as a whole, all of a society's constituents have a right to be represented in the bargaining process and have their concerns recognized when choosing the principles that govern financial distress.[30] Consequently, the bankruptcy choice model lacks the controversial exclusions of the Jacksonian model, such as excluding people who have no formal legal rights or who derive their rights from non-contractual relationships, i.e. victims of tortious acts.[31] In Korobkin's model, the participants to the bargain are placed behind a "veil of ignorance" with respect to their place in society.[32] The fact that they do not know whether they stand as creditors, employees, tort victims, community members, or equity holders hinders each participant's ability to "tailor principles to his advantage" because no one can estimate the financial impact of bankruptcy on his or her own interests.[33] Under these conditions, society will reject the Jacksonian principle of creditor wealth maximization and will choose the "principle of rational planning" that will mitigate the harmful consequences of bankruptcy for the parties who have the most to lose in financial distress.[34] Typically, the parties with the most to lose also have the worst prospects for avoiding harms and toward whom bankruptcy law should have re-distributional impulses.[35]

3. Recapitulation

To recapitulate, the differences separating traditionalists from proceduralists can be summarized by three major points.[36] The first difference concerns the role of bankruptcy in keeping a firm intact as a going concern.[37] Traditionalists believe that giving failing firms a chance to reorganize is an essential bankruptcy aim. Otherwise, jobs are lost and communities are adversely affected. In contrast, proceduralists believe that a firm "must live or

[29] Korobkin, *supra* note 3, at 544.
[30] *Id.* at 555–57.
[31] *Id.* at 554.
[32] *Id.* at 559 (quoting JOHN RAWLS, A THEORY OF JUSTICE, 136–42 (1971)).
[33] *Id.*
[34] *See id.* at 545,581–89.
[35] *Id.* at 581–89.
[36] Baird, *supra* note 19, at 577–80.
[37] *Id.* at 577–78.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

die in the market."[38] The only aim of bankruptcy is to avoid premature liquidation of a failing firm because of the uncoordinated actions of creditors.[39]

The second divergence relates to different visions as to bankruptcy law's place within the legal system as a whole. Specifically, is bankruptcy "a closed or an open system?"[40] According to Professor Baird, traditionalists underestimate the effects of certain substantive bankruptcy rules on the *ex ante* behavior of debtors and creditors. Proceduralists are concerned about these *ex ante* incentives. Different values in and out of bankruptcy might "do more harm than good, even for the particular group one is trying to protect."[41] Forum shopping threatens the prebankruptcy contractual entitlements of creditors and could push creditors to lend less or to increase the cost of capital. This, in turn, constricts economic growth.[42]

Finally, traditionalists and proceduralists disagree over how to enforce particular bankruptcy rules once these are adopted. Traditionalists consider the judge's role instrumental.[43] Judges should implement bankruptcy's equity goals on a case-by-case basis and should be given broad discretionary powers to undertake such a role. Proceduralists, on the other hand, believe that judges should not commit to any particular outcome. Judges are "disinterested arbiters" whose only task is to control the parties' conflicting interests and to ensure the transparency and integrity of the bankruptcy procedure.[44] By remaining disinterested, judges allow the parties to "make their own decisions and thereby choose their own destinies."[45]

B. Auction Theory

Proceduralist mistrust of judges led some law and economics scholars to push Professor Jackson's premises even one step further.

---

[38] *Id.* at 578.
[39] *Id.*
[40] *Id.* at 589–92.
[41] *Id.* at 578.
[42] *Id.*
[43] *Id.* at 593.
[44] *Id.* at 579
[45] *Id.* at 580

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

1. Auction Bankruptcy

In *The Uneasy Case for Corporate Reorganizations*,[46] Professor Baird advocates a full market solution to financial distress. Because bankruptcy addresses only creditor-distribution questions, it always involves a sale of assets and a division of the sale's proceeds among creditors.[47] Hence, the only difference between liquidation and reorganization is in the form the sale of assets takes. In liquidation, ownership rights are effectively sold on the open market to third parties, while in reorganization, these rights are fictively sold to the debtor's claimholders in exchange for the cancellation of their prebankruptcy rights.[48] If optimal bankruptcy rules should only reflect the creditors' hypothetical bargain, reorganization is warranted only if creditors would agree *ex ante* to a hypothetical sale of assets instead of a true one.

Professor Baird believes that such a bargain is improbable especially when the debtor is a publicly held corporation.[49] Indeed, a market sale does not necessarily destroy the going-concern value of the debtor because the corporation can be sold as a functioning entity. A market sale provides a superior valuation compared to a hypothetical sale, which only imperfectly mimics market appraisals. Furthermore, third-party buyers bear the consequences of wrongly valuing the bankrupt company. If buyers overvalue the company, they suffer lower returns on their investments. On the other hand, if buyers undervalue the company, they could loose the bid to the benefit of a competing investor.[50] Judges, who generally have limited business experience, cannot determine a better value for the debtor's business. Judges tend to overvalue distressed companies because they are not investing their own money.[51] Professor Baird argues for the residual owners to conduct the market sale because they have the strongest incentive to obtain the highest available sale price.[52]

---

46 Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

47 *Id.* at 127.

48 *Id.*

49 *Id.* at 128.

50 *Id.* at 136.

51 *Id.* at 136–38. (citing Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 577–78 (1950); Paul F. Festersen, *Equitable Powers in Bankruptcy Rehabilitation: Protection of the Debtor and the Doomsday Principle*, 46 AM. BANKR. L.J. 311, 329 (1972); J. Ronald Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 UCLA L. REV. 540, 548–49 (1973)).

52 Baird recognizes the difficulties inherent in finding the residual claimants for this purpose. *Id.* at 137.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Auctions limit the costs of bankruptcy, especially costs related to the policing of hypothetical sales, where parties behave strategically and manipulate the debtor's value in order to maximize their recovery.[53] Professor Jensen emphasizes the distortions that reorganization under the Bankruptcy Code creates when it allows for violations of the absolute priority rule.[54] All participants in bankruptcy proceedings have the right incentives to provide an unbiased estimation of the debtor's value. Senior creditors underestimate the debtor's value in order to obtain higher ownership rights in the restructured business.[55] Equity holders overestimate the debtor's value to keep a minimum ownership stake in the failing company.[56] Junior creditors overestimate the debtor's value when they believe their claims to be out of the money and underestimate the debtor's value when they believe their claims to be in the money.[57] Finally, managers want to keep their jobs and, therefore, will estimate the debtor's value in such a way as to keep themselves employed.[58] By allowing all parties, claimholders and non-claimholders alike, to make an all cash bid and buy the failing company, auctions eliminate the problem of biased estimations because bidders back their estimations with their money.[59] This process divides bankruptcy into two complementary stages. First, the market does what it does best by deciding the final value of the debtor's firm. Second, judges do what they do best by adjudicating the claims among creditors by following the APR.[60]

2. *Partial Auction Bankruptcy*

Yet a rule that mandates an all cash sale of a bankrupt company can be too radical, disruptive, and costly for it to constitute a viable reform agenda. To address this critique, Professor Mark Roe proposes what he calls a more practical and realistic market solution to bankruptcy valuation. He proposes selling part of the failing company on the open market - for example, ten percent of new common stocks - and then extrapolating the value of the firm as

---

[53] *See generally* Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633 (1993).

[54] Michael C. Jensen, *Corporate Control and the Politics of Finance*, *in* CORPORATE BANKRUPTCY, ECONOMIC AND LEGAL PERSPECTIVES 329, 334 (Jagdeep S. Bhandari & Lawerence A. Weiss eds., 1996).

[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] *Id.*

[60] *Id.* at 335.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

a whole from the price received.[61] However, this is only possible if the court confirms a plan, with an all common-stock capital structure. If it does, the court can then divide claims following the APR.[62] By auctioning only ten percent of the restructured company's common-stocks, Professor Roe's proposal lowers transaction costs and adequately addresses the liquidity problem that typically faces the sale of a whole company on the market.

Professor Roe's proposal, however, is not without flaws. First, creditors who have a controlling stake in the restructured company might value the offered shares at a premium in function of the private benefit of control that could be derived from their dominant position. This could bias the overall value of the restructured firm upward.[63] The partial value of the firm's equity is not necessarily representative of the whole firm's value. Second, Professor Roe's proposal still allows for strategic behavior by parties involved in the bankruptcy. For example, old equity holders could overbid on the new company's stocks in order to increase the overall value of the restructured firm and, in turn, increase their ownership rights. Also, senior creditors could underbid to depress the overall value and freeze-out old owners.[64] Finally, Professor Roe's proposal fails to completely address bankruptcy delays and valuation issues completely. The claims of the various parties in the bankruptcy case still have to be assessed, and the valuation disputes simply shift costs to other focal points.[65]

---

[61] Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, *in* CORPORATE BANKRUPTCY, ECONOMIC AND LEGAL PERSPECTIVES 357, 363 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

[62] Professor Roe supplies four reasons why bankruptcy law historically mistrusted market valuations. First, the market for bankrupt firms was infantile in the last century. *Id.* at 356. Second, the dominant ideology during this period, especially following the Great Depression, was strongly biased against market solutions. *Id.* Third, most bankrupt firms were small and family owned. *Id.* Smaller firms, even today, face a distorted and imperfect market due to strong asymmetric information and problems of idiosyncratic valuations. *Id.* Finally, the market could compel courts to choose a harsh liquidation solution with associated unpopular job losses. *Id.* These factors are long gone, or at least their strength is greatly diminished. *Id.* at 357. Markets have now matured and specialized in all kind of securities and debt, including the most risky of these. *Id.* Anti-market ideology has rescinded. *Id.* Asymmetric information and unpopular liquidations exist even without a market sale. *Id.* Professor Roe cites studies that show that the market for bankrupt securities is relatively efficient. *Id.* Hence, they are at least equal, if not superior, to judicial valuation. *Id.*

[63] *Id.* at 361.

[64] *Id.* at 364.

[65] *Id.* at 365.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

3. *Option Bankruptcy*

Often a viable debtor with high going-concern value has difficulty finding a willing buyer because of asymmetric information and market illiquidity. In such a situation, creditors are better off if they trade their pre-bankruptcy claims for a controlling equity stake in the restructured debtor. Questions remain about how to value the debtor and how to divide its assets among creditors efficiently with minimal bargaining and litigation costs. In this context, Professor Lucian Bebchuk proposes an "option" approach to corporate reorganization that does not require courts to identify the value of the restructured firm immediately before dividing its shares among claimholders.[66] The division is done in accordance to the APR and the option method guarantees that no participant can get less than what they are entitled to under this rule.

Under the option model, each participant receives security rights issued by the reorganized firm with an aggregate value that is a function of the overall value of the restructured company. For example, suppose there are 100 senior creditors and 100 junior creditors, each owed one dollar.[67] Suppose further that there are 100 equity holders each holding one unit of common-stock.[68] Suppose that the reorganized company, RC, has 100 units of equity each worth some value "V."[69] If V is less or equal to one dollar, every senior creditor gets one unit of equity worth V.[70] The junior creditors and equity holders get nothing.[71] If V is worth less than two dollars but more than one dollar, each senior creditor gets 1/V unit of RC (worth one dollar) and each junior creditor gets the rest (1 – (1/V), which is worth V - $1).[72] Equity holders get nothing.[73] Finally, if V is worth more than two dollars, the senior and junior creditors get paid in full (1/V unit each and worth $1).[74] Equity holders get the rest (1 – (2/V), which is worth V - $2).[75] In other words, there is no need to determine *ex ante* the overall value of the company (100*V). Participants get rights that

---

[66] Lucian Arye Bebchuk, *A New Approach to Corporate Reorganization*, 101 HARV. L. REV. 775, 785–86 (1988).

[67] *Id.* at 781–82.

[68] *Id.* at 782.

[69] *Id.*

[70] *Id.*

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] *Id.* at 783.

[75] *Id.*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

are a function of V and that guarantee to each participant its entitlement under the APR whatever the value V takes afterward.[76]

At a later stage, creditors might disagree with the market valuation of the new company's shares. The market might value V at one dollar, but the junior creditors might believe that V is worth $1.50 and equity holders might believe that V is worth $2.50. Professor Bebchuk proposes to attach to the rights of each class of claimholders an *option* to redeem the ownership rights of all the other superior classes. For example, if junior creditors believe that senior creditors receive more than they are entitled, they can exercise their option by redeeming the senior creditors in full and obtaining in return the undervalued equity stock. Equity holders can do the same by redeeming in full the senior and junior creditors.[77]

Table 1: The Distribution of Rights[78]

Senior Creditors:	Each senior creditor receives one type-A right. A type-A right may be redeemed by the company on the redemption date for $1. If the right is not redeemed, on the redemption date its holder will be entitled to receive one unit of RC.
Junior Creditors:	Each junior creditor receives one type-B right. A type-B right may be redeemed by the company on the redemption date for $1. If the right is not redeemed, on the redemption date its holder will have the option to purchase one unit of RC for $1.
Equity holders:	Each equity holder receives one type-C right. A type-C right may not be redeemed by the company. The holder of such a right on the redemption date will have the option to purchase one unit of RC for $2.

The option model eliminates the need to estimate the overall value of the restructured company on the spot. Yet bankruptcy courts must still value the relative claims of creditors in order to distribute bankruptcy rights according to the debtor's overall value. Furthermore, secured creditors are entitled to the proceeds of their collateral under the APR, which must be determined using

[76] *Id.* at 785.
[77] *Id.* at 786–88.
[78] *Id.* at 787.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

the same costly litigation and bargaining process that the auction and the option models try to avoid.

Professors Lucian Bebchuk and Jesse Fried address this problem by dividing the claim of a secured creditor into its secured and the unsecured portions.[79] The secured claim's value is equivalent to the value of the non-recourse note which is backed by the collateral.[80] The non-recourse note can hence be auctioned shortly before the end of the bankruptcy proceeding.[81] The bidder is willing to pay the note's market value because the note matures immediately *after* the end of the bankruptcy process when the debtor is liquid and able to pay it in full.[82] The note's price represents the value of the creditor's secured claim in bankruptcy, and its proceeds will be used to pay the creditor's secured claim in full.[83] The remaining claim, if any, represents the creditor's unsecured claim.[84]

The secured/unsecured apportionment approach complements the option model to bankruptcy by further reducing bargaining and litigation costs and by improving the method of valuing assets and claims. Moreover, the approach provides the benefits of market valuation without the need to conduct what is effectively an auction of collaterals during bankruptcy at a time when the debtor does not have the available liquidity to participate in the bidding procedure, and when its going-concern value could be threatened by losing important assets. After bankruptcy, the debtor is solvent and able either to redeem the amount it is owed (if it considers the collateral undervalued) or abandon the collateral (if it considers the collateral overvalued or unnecessary for its business).[85]

4. Critique of Auction and Market Theories

Not all scholars believe that auction bankruptcy and market valuation models are superior to the current bankruptcy system. To measure the effectiveness of such proposals, Judge Frank Easterbrook points to equity receiverships, the ancestor of modern bankruptcy law, which typically ended

---

[79] Lucian Arye Bebchuk & Jesse M. Fried, *A New Approach to Valuing Secured Claims in Bankruptcy*, 114 HARV. L. REV. 2386, 2391 (2001).
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.* at 2391–92.
[84] *Id.* at 2392.
[85] *Id.* at 2391–92.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

bankruptcy proceedings with inefficient auctions.[86] Modern bankruptcy law replaced equity receiverships with collective procedures that facilitate bargaining among stakeholders in order to avoid cumbersome auction sales. If modern bankruptcy law has endured for so long, it is probably because the bankruptcy system in its current form is efficient. The only other reason that modern bankruptcy law has remained so resilient is that it might be redistributing wealth to a concentrated and politically influential group that opposes change. Judge Easterbrook, claims, however, that there are no redistributive consequences for choosing market valuations instead of hypothetical valuations in bankruptcy. Indeed, the violation of APR in particular cases causes some parties to win (i.e. junior creditors) and other parties to lose (i.e. senior creditors) *ex post*, but it does not imply a transfer of wealth between parties *ex ante*, "given responses to known rules."[87] For example, a rule that is harsher on junior creditors does not necessarily redistribute wealth or create political support in favor of senior creditors. Junior creditors can simply increase lending rates to compensate for the augmented risks they now face under the stricter regime. This would only hurt worthy ventures that must cope with a higher cost of capital. Furthermore, it is unrealistic to separate suppliers of capital into segregated and hermetic groups.[88] Finally, auctions are not necessarily cheaper than judicial bargaining. Judge Easterbrook analogizes the auctioning of a bankrupt firm to an initial public offering (IPO) of a risky company with uncertain prospects. The greater the risks, the more potential investors must spend on investigating whether to participate in the risky venture. While the IPOs successful managers promise to keep running the growing company after going public, the creditors of the failing firm have neither the knowledge of the debtor's affairs nor the will to keep an investment in the venture.[89] Studies done by Lawrence Weiss and by Jay Ritter on the costs of bankruptcy and IPOs, respectively, show that the average costs of bankruptcy are significantly lower than those of an IPO.[90] To Judge Easterbrook, this indicates that the current bankruptcy system would be more cost-efficient than auctions and market bankruptcy models.

---

[86] Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient*? 27 J. FIN. ECON. 411, 413 (1990).

[87] *Id.* at 414.

[88] *Id.*

[89] *Id.* at 415.

[90] *Id.* (citing Jay R. Ritter, *The Cost of Going Public*, 19 J. FIN. ECON. 269 (1987), and Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990)).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

C. Contractual Bankruptcy

Auction models are built on a "one size fits all" premise. Auctions are more efficient because they strictly apply APR and limit litigation and bargaining costs that saddle judicial restructurings. The mandatory nature of bankruptcy law is an anomaly, however, when compared to the general, freedom of contract, allowed in most relationships among consenting parties. To the proponents of contractual bankruptcy, also known as "contractualists," the same rationale that stands behind giving investors the freedom to establish rules that better fit their particular transactions also justifies making bankruptcy law a default system that parties can waive or modify *ex ante*. Investors are better aware of what rules are most efficient to govern their particular transactions. To contractualists, the APR is not a goal that stands by itself. Respecting the APR facilitates the process of contracting for bankruptcy *ex ante* and lowers otherwise prohibitive transaction costs.

1. A Menu Approach

Professor Robert Rasmussen suggests a menu approach to corporate bankruptcy.[91] Under his proposal, Congress would adopt compulsory bankruptcy rules in order to protect the rights of tort victims and other non-consensual creditors.[92] However, consensual investors would choose from a "menu" of bankruptcy laws. In addition, investors could negotiate for whatever bankruptcy rules they desire so long as any additional transactional costs this negotiation imposes are compensated for by an improved insolvency arrangement.[93] Ideally, Professor Rasmussen proposes the ideal menu with four choices for bankruptcy regimes. The first choice is a regime that would mimic a state law collection system.[94] The second choice is a liquidation regime where the debtor is auctioned and sold to the highest bidder on the open market.[95] The third choice is regime that stays all creditors' enforcement actions except those of the debtor's principal financier such as a major bank.[96] The extensive relationship that the major bank has with the debtor gives it an informational advantage that better enables it to decide, compared to any other

---

[91] Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 53–54 (1992).

[92] *Id.* at 53.

[93] *Id.* at 53–54.

[94] *Id.* at 100–01.

[95] *Id.* at 102–03.

[96] *Id.* at 106.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

parties, including other creditors and the court, whether the debtor deserves another chance to restructure.[97] This regime pressures the debtor to strengthen its governance structures in order to merit the complacency of its principal financier.[98] The fourth and final choice is a regime that calls for Congress to allow the debtor and its creditors to create their own set of insolvency rules while safeguarding the interests of non-consensual creditors.[99]

Under the menu approach model a company chooses, and locks into, one bankruptcy regime upon contract formation in order to set the rules of the game at an early stage. The model provides enough flexibility for the debtor to shift between bankruptcy regimes whenever the debtor's situation genuinely requires a change. However, restrictions prevent the debtor from using this option in a strategic way at the expense of its creditors' rights. For example, a debtor who wishes to move from reorganization to a liquidation regime can do so without the previous consent of its creditors, while a move in the opposite direction requires the previous consent of all its creditors. A move from any bankruptcy regime to the first-come first-served state collection system privileges those creditors possessing informational advantages; hence, such move is not possible without the consent of all creditors, and the change affecting the debtor's charter does not enter into force for a year. Finally, a move away from the state collection system introduces a stay on creditors' enforcement rights, which would require unanimous creditor consent. Similarly, a move away from the selective stay would require the consent of the principal financier whose rights are not stayed under the selective stay regime.[100]

2. *Waiver Bankruptcy and Chameleon Equity*

Other scholars have a more limited reform agenda. Professor Marshall Tracht, for example, argues for making current bankruptcy laws default rather than mandatory rules.[101] Courts can always protect abused and unsophisticated debtors by avoiding the creditors' bargain and re-applying bankruptcy law as a set of default rules. Another scholar, Professor Steven Schwarcz advocates making certain non-essential bankruptcy rules optional which the debtor could

---

[97] *Id.*

[98] *Id.*

[99] *Id.* at 106–07.

[100] *Id.* at 119–21.

[101] Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 303 (1997).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

waive to fit its particular needs.[102] For example, upon filing for bankruptcy, the debtor could waive its right to an automatic stay in order to easily obtain new and cheaper credit more easily. The debtor should receive a value that is at least equivalent to the rights it waives. The agreement also should not have "a secondary material impact" or manifestly impair the debtor's ability to reorganize.[103] A third scholar, Professor Barry Adler, advocates a bankruptcy contract that he calls "Chameleon Equity."[104] The debtor and his creditors agree *ex ante* on establishing a firm that issues no traditional debt and that structures its capital in strict hierarchy with a common stock class at the bottom and numerous other preferred equity classes on top. Upon insolvency, such a firm would lose its lowest equity layer, which would be replaced by the second lowest equity class.[105] Assuming all else remains constant, the debtor continues losing and replacing layers of equity as it works its way out of bankruptcy – thereby changing its capital structure to fit its needs, like a chameleon.[106]

3. A Skeptical View

Not all scholars are comfortable with these proposals. Professor Charles Tabb, for one, is skeptical of the contractualist theories. He questions the premise that it is feasible and efficient to move away from Jackson's hypothetical bargain toward an actual bargain between investors.[107] Contractualists assume parties are rational. Professor Tabb, in response, points to behavioral economic studies that show people act in systematically irrational ways.[108] Bankruptcy contracts do not lead to efficient and non-redistributive arrangements. Only mandatory bankruptcy rules achieve this goal because

---

[102] Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 518–19 (1999).

[103] *Id.* at 556.

[104] Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 312 (1993).

[105] *Id.*

[106] Professor Adler recognizes that Chameleon Equity cannot work unless certain requirements are met: (1) the company should not be allowed to issue debt; (2) the law should allow the debtor to waive its right to file for bankruptcy; (3) the law should find other incentives to compensate the losses the debtor incurs by giving up its tax deductions on debt payments; (4) finally, the law should adequately address tort liability that would give tort victims priority over all other claimants—equity holders—in a Chameleon Equity firm. *Id.* at 333–41.

[107] *See* Charles Tabb, *Of Contractarians and Bankruptcy Reform: A Skeptical View*, 12 AM. BANKR. INST. L. REV. 259, 260 (2004).

[108] *Id.* (citing Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051 (2000)).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

they take into account the interests of all the parties, including those of non-adjusting creditors.[109] Contractualists also assume a perfect market exists in order to avoid the problem of asymmetric information that investors face when negotiating and deciding *ex ante* the rules that should govern the bankruptcy of their debtors. Yet, by definition, bankruptcy implies an imperfect and distorted market where the only cost-efficient contract is necessarily an incomplete one. The range of future outcomes is so large and uncertain that it is costly to address all potential issues *ex ante*. The contract intentionally leaves some important aspects to be sorted out if and when financial distress occurs. At that time, more information is available to stakeholders to determine how best to maximize the debtor's value.[110] Finally, Professor Tabb questions whether reforming bankruptcy in order to allow freedom of contract would open a Pandora's box with consequences that are hard to measure. Some contractual models work only if the rest of the legal world changes, such as tax, corporate, and tort laws. One can wonder whether this is worth the change, especially when no one can measure in advance the consequences of such a massive transformation.[111]

4. Bribe for Contract Bankruptcy and Critique of the Theory

Professor Alan Schwartz builds a theoretical model to prove the inefficiencies of mandatory bankruptcy rules.[112] He assumes a system where investors can negotiate the bankruptcy rules that should govern the debtor's financial distress *ex ante*, before they lend money, or *ex post*, upon insolvency.[113] The parties can choose either liquidation or reorganization. The debtor's managers desire reorganization because it preserves their control over the business.[114] If liquidation maximized the recovery rates of creditors, creditors would negotiate a liquidation regime *ex ante* with the debtor by bribing the managers with an amount equivalent to the private benefits of control they would have to forgo by agreeing not to file for reorganization.[115] Creditors prefer to negotiate *ex ante* because the bribe they would have to pay *ex-post* for choosing liquidation would probably be higher. During financial distress, it is certain that the company will choose reorganization and therefore

[109] *Id.*
[110] *Id.* at 268–69.
[111] *Id.* at 267–68.
[112] Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 346 (1999).
[113] *Id.* at 346–47.
[114] *Id.* at 346.
[115] *Id.*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

more bargaining power with which to extort a higher bribe. On the other hand, if reorganization is the more efficient choice, creditors will not negotiate a deal with the debtor *ex ante* for the debtor will choose reorganization *ex-post* regardless. A bankruptcy system that only allows negotiations *ex-post* is not optimal; in particular situations, parties are better off negotiating bankruptcy rules *ex ante*.[116]

A major obstacle to the implementation of all contractual models is the problem of inter-temporal coordination. The debtor borrows from multiple creditors at different times during which its financial circumstances are constantly changing. In Schwartz's model, for example, the optimal bankruptcy regime that creditors have chosen, and the bribe that creditors have paid, could become moot. To Professor Schwartz, the debtor discloses the correct bribe amount each time it enters a transaction with a creditor because if the debtor inflates the bribe, he risks either losing the loan or increasing the burden of his interest payments. If, however, the debtor understates the bribe, he loses the private benefits of control that he would have gained if he had chosen the inefficient bankruptcy rule. Because the debtor always discloses the optimal bribe, Professor Schwartz proposes that all previous bribes be updated to equal the bribe between the debtor and his latest creditor.[117] Creditors have conflicting interests regarding whether to choose liquidation or reorganization but only if their reimbursement priorities vary under both bankruptcy systems. These conflicting interests disappear, however, if both liquidation and reorganization respect the APR. The APR removes the barriers to writing bankruptcy contracts.[118]

Professor Lynn LoPucki rejects Professor Schwartz's model as theoretically and factually wrong.[119] Theoretically, the model is wrong in assuming that the debtor will disclose the true value of the bribe.[120] The debtor knows that the first creditors he contracts with will not be the last.[121] His incentive, at this early stage of financing, is to minimize the bribe in order to lure creditors with their recovery prospects. A lower bribe signals better governance mechanisms and could lower the firm's cost for capital. The first

---

[116] *Id.* at 346–47. For a mathematical explanation of the model, see Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1820–33 (1998).

[117] Schwartz, *supra* note 116, at 1833–36.

[118] *Id.* at 1836–39.

[119] *See* Lynn LoPucki, *Contract Bankruptcy, A Reply to Schwartz*, 109 YALE L. J. 317 (1999).

[120] *Id.* at 339.

[121] *Id.*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

creditor is aware of the debtor's biased incentives and will not enter into a contract with the debtor. This is true even when the debtor genuinely wishes to disclose the optimal bribe, because the creditor has no verifiable means to know the optimal amount.[122]

Moreover, the APR does not eliminate the conflict of interest between creditors, especially between secured and unsecured creditors.[123] For example, the expected recovery rate in liquidation for creditors as a *whole* might be superior to their expected recovery rate in reorganization. However, when *unsecured* creditors have no chance to recover in liquidation, but do have slight chance to recover in reorganization, they will prefer to contract for a reorganization regime even under a strict APR.[124] This makes the inter-temporal problem a formidable barrier that is impossible to overcome, for Schwartz's model is based on the ability of the last creditor to genuinely represent the interests of all previous creditors.[125]

To Professor LoPucki, Schwartz's model is also factually wrong.[126] Today, bankruptcy contracting is a common but limited practice.[127] Currently, workouts and asset securitization are the only available forms of contract bankruptcy.[128] Professor LoPucki notes that in both these types of contracts, creditors that stand behind the deal fail to take into account the interests of other creditors.[129] For example, secured creditors do not include unsecured creditors when they contract with the debtor for stay-waivers in workouts.[130] Similarly, asset securitizations do not protect future creditors of the originator. In both examples, wealth redistribution benefits the contracting parties, not the general social welfare.[131]

D. The End of Bankruptcy?

In fact, to Professors Baird and Rasmussen, amending the Bankruptcy Code is not a prerequisite for the emergence of auction and contract

---

122 *Id.* at 323–26.
123 *Id.* at 327.
124 *Id.* at 328.
125 *Id.* at 327–30.
126 *Id.* at 333.
127 *Id.*
128 *Id.* at 336.
129 *Id.* at 338.
130 *Id.*
131 *Id.* at 333–39.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

bankruptcy. Today, corporate reorganization in its traditional meaning has "all but disappeared."[132] In practice, corporate bankruptcy is no longer a forum where the debtor and its creditors meet to negotiate the restructuring of the company's capital, but rather a convenient place to effectively auction the company to the highest bidder. The authors refer to Ronald Coase's theory of the firm in order to explain this phenomenon. To Coase, transaction costs are the only reason that justify pooling assets together in one legal entity instead of relying on market-coordination via the supply and demand mechanisms. But in an era where the economy is mostly service based, assets that are dedicated to a particular firm are, most likely, intangibles.[133] These assets have no going-concern value when the firm is bankrupt because bankruptcy reflects the failure of the firm's underlying business model.[134] Moreover, the increased sophistication and liquidity of the market makes it easier to sell both small and larger companies at going concern value both in and out of bankruptcy.[135] Contract bankruptcy is also on the rise. Investors today resort to sophisticated techniques in order to allocate control rights among themselves in anticipation of bankruptcy. For example, creditors reserve the right to appoint their representative on the debtor's board of directors when the financial triggers and benchmarks that are defined by contract materialize.[136] The end of bankruptcy reflects the inferiority of judicial bargaining compared to the more efficient auction and contractual bankruptcy models.

Professor LoPucki disagrees. In two empirical studies of firms that emerged out of bankruptcy as public companies from 1982 to 1986 and 1991 to 1996, LoPucki and others find that, on average, companies emerged at forty-four precent and seventy-seven percent of their pre-bankruptcy size, respectively.[137] Similar firms in 2001 emerged at an average of seventy-five percent.[138] According to LoPucki, the forces that hold firms together grow stronger rather than weaker with time. LoPucki rejects Baird's and

---

[132] Baird & Rasmussen, *supra* note 4, at 751.

[133] *Id.* at 756–58.

[134] *Id.* at 758.

[135] *Id.* at 786–88.

[136] *Id.* at 778–85.

[137] Lynn M. LoPucki & Joseph W. Doherty, *Why Are Delaware and New York Reorganizations Failing?*, 55 VAND. L. REV. 1933 (2002); Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 615 (1993).

[138] Lynn M. LoPucki's Bankruptcy Research Database, available at http://lopucki.law.ucla.edu (last visited June 24, 2008).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Rasmussen's interpretation of Coase's theory of the firm.[139] Baird and Rasmussen focus exclusively on intra-company relationships with and among commodities without regard to those among labor.[140] Yet relationships with labor are more complex and costly.[141] They create, with time, a smooth and competitive operating firm that is worth saving even in a service economy.[142] Here, the going-concern value of the firm does not exclusively reside in its intangible assets but more so in the interaction among its human capital.[143]

Finally, LoPucki believes that the lender-control agreements to which Baird and Rasmussen refer cannot solve the bankruptcy governance problem nor facilitate coherent decisionmaking within the bankrupt firm. Hence, these agreements cannot replace mandatory bankruptcy rules. Indeed, these contracts do not identify the residual owners, nor do they provide a mechanism to do so. Creditors contract to take control of the debtor even before stockholders completely loose their ownership interests in the debtor. This gives creditors the leverage they need to liquidate the debtor without risking their investments. Moreover, contracts that mandate appointing new board members upon default, or at near default, do not necessarily transfer total control to the creditors. Board members typically are selected amongst independent candidates with enough stature and with fiduciary duties to all stakeholders.[144] In LoPucki's opinion, bankruptcy is doing well and is thriving.

E. Reversal: APR Violation is Efficient and Conforms to the Creditors' Bargain

It is not enough to reject the auction and contractual models by only pointing to their weaknesses and shortcomings. In order to prove the superiority of bankruptcy bargaining, the proponents of the current system have to demonstrate that APR violations, which constitute the major feature of bankruptcy bargaining, match the efficiency goal. Professors Thomas Jackson and Robert Scott adopt this stance in their *Essay on Bankruptcy Sharing and*

---

[139] Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645 (2003).
[140] *Id.* at 657–59.
[141] *Id.*
[142] *Id.*
[143] *Id.* at 657–59.
[144] *Id.* at 660–65.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

the Creditors' Bargain.[145] By doing so, Jackson rebuts a major premise of the school of thought that he has contributed to founding, and imperfectly, but certainly, joins traditionalists in condoning redistribution in bankruptcy. He does so by using arguments that pertain to efficiency and to the collective interests of creditors. To Jackson and Scott, the enriched creditors' bargain theory gives additional arguments as to why contractual bankruptcy is not a practicable solution to financial distress.

1. The Notion of Common Disasters

Typically, costs are assigned to the best risk monitors, such as the costs of bankruptcy that stockholders bear as the result of their investment decisions. Risks can also be transferred to risk-neutral investors, such as unsecured creditors. By assigning and transferring risks in this manner, the overall cost of capital decreases.[146] However, individual risk-bearing techniques cannot prevent nor limit the risks of common disasters. These are contingencies that are inherent in all business activities for which materialization or consequences cannot be influenced by the actions of individual parties, such as competent or incompetent managers or monitors. Common disasters can be addressed only by devising a risk-sharing mechanism that would reduce the amount of uncertainty and the potential for loss that each party faces if these risks materialize.[147] To Professors Jackson and Scott, it is impossible to distinguish common disasters from those that can be blamed on individual actions *ex ante*.[148] The important transaction costs that this exercise entails would exceed the benefits of the bargain, especially for repeat lenders.[149] "A prepaid insurance scheme that effects a partial across-the-board reduction in the returns to secured creditors may be the only feasible implementation option."[150] Such prepaid insurance schemes decreases the risk of capital and increases, on average, the debtor's overall value and creditors' overall returns.

The authors draw three conclusions from this theoretical discussion. First, *ex-post* redistribution is not incompatible with the creditors' *ex ante* objective

---

[145] Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989).

[146] *Id.* at 166 (citing Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979)).

[147] *Id.*

[148] *Id.* at 167.

[149] *Id.*

[150] *Id.* at 168.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

of maximizing the debtor's value. The re-distributional impulses of the Bankruptcy Code, such as occasional deviation from the APR, are congruent with efficient bankruptcy policies.[151] Second, the enriched creditors' bargain theory justifies the mandatory nature of bankruptcy law and demonstrates why freedom of contracts does not fit this discipline. It is technically impossible to draft contracts that can accomplish both collective and distributional objectives.[152] Finally, the authors contend that the observed inefficiencies of the bankruptcy system reflect a defective implementation of the bankruptcy rules rather than inadequate theoretical premises underlying the Bankruptcy Code.[153]

2. *Skeptical Critic*

The enriched creditors' bargain theory is not without flaws. According to Professor Roe, readily available indicators can easily identify various common disasters, such as a general decline in prices or an increase in industry costs.[154] If these risks are not actually identified in contracts *ex ante*, it is because the parties involved do not agree to the risk sharing strategies in the first place. To Professor Adler, the *actual* bargain among investors is not silent on how to allocate insolvency risks; contracts expressly allocate residual risks first to equity holders, then to unsecured creditors, and finally to secured creditors. The actual bargain contradicts the hypothetical bargain that Jackson and Scott envision.[155] Moreover, the Bankruptcy Code adopts many re-distributional rules without regard to the nature of the corresponding risk.[156] Finally, a risk-sharing rule is less efficient than the APR because the latter pushes creditors to investigate their debtors more intensely prior to granting a loan. Risk-sharing increases the costs of monitoring during the length of the business relationship and could discourage efficient transactions from going forward.[157]

---

151 *Id.* at 169.
152 *Id.* at 203.
153 *Id.* at 202.
154 Mark J. Roe, *Bankruptcy, Priority and Economics*, 75 VA. L. REV. 219, 223 (1989).
155 Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 461 (1992).
156 Roe, *supra* note 154, at 229–38.
157 *Id.* at 219.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

F. *Economists Join the Debate: APR Violation is Not Inconsistent with Efficiency*

Various other economic scholars defend bankruptcy's re-distributional impulses on efficiency grounds. In this section, I review the most important of these arguments.

1. *The Case for Management Bias in Bankruptcy Reorganization*

Elazar Berkovitch et al. argue that an efficient bankruptcy law should work primarily as a "commitment device" that encourages debtors to behave optimally *ex ante*.[158] Successful ventures typically require that entrepreneurs make firm-specific capital investments.[159] Under the APR, however, creditors will reap all these investments whenever, upon financial distress, the debtor and his creditors renegotiate their contracts based on each party's *ex post* bargaining powers.[160] Facing the prospects of receiving zero return on their investment upon financial distress, entrepreneurs have little incentive to invest their personal efforts *ex ante*. As a consequence, bankruptcy law should balance the playing field *ex post*, by strengthening the debtor's negotiating position and forcing creditors to bargain with debtors and to accept some concessions. This entails a slight deviation from the APR. If guaranteed a minimum return on their investments, even upon financial distress, entrepreneurs become more prone to make firm specific investments *ex ante*.[161]

To Paul Povel, the level of available information in a particular economy determines what bankruptcy regime is optimal. A "tough" bankruptcy regime follows APR strictly. A "soft" bankruptcy regime allows minor re-distribution and small deviations from the APR. In economies where asymmetric information is the rule, management observes financial distress much earlier than creditors do. The latter are better off if they allow slight deviations from the APR for this encourages managers to address financial distress at an earlier stage where recovery is more possible and more sizeable. The APR is a sub-optimal rule when considerations with respect to efficiency require the adoption of a soft bankruptcy regime.[162]

---

[158] Elazar Berkovitch, Ronen Israel & Jaime F. Zender, *The Design of Bankruptcy Law: A Case for Management Bias in Bankruptcy Reorganizations*, 33 J. FIN. & QUANTITATIVE ANALYSIS 441, 442 (1998).

[159] *Id.*

[160] *Id.*

[161] *Id.* at 443.

[162] Paul Povel, *Optimal 'Soft' or 'Tough' Bankruptcy Procedures*, 15 J. L. ECON. & ORG. 659 (1999).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Elazar Berkovitch et al. further elaborate on this informational aspect.[163] The authors assume a bankruptcy law with two chapters.[164] The creditor-chapter allows creditors to push debtors into bankruptcy in order to liquidate them.[165] The debtor-chapter allows debtors to file for bankruptcy protection in order to retain control and to reorganize their businesses. To Berkovitch et al., the creditors' ability to get information on their debtors and the debtors' ability to use its private information strategically determines which bankruptcy chapter best fits with a particular economy.[166] To the authors, an economy can have one of three distinct financial systems. The first is a market-based-system where corporations finance their capital needs through financial markets. Information in the market-based system is abundantly available and creditors deal with corporations at arm's length. The managers of the debtor do not see nor control the information that creditors process. They cannot use private information strategically. Because enough information is available for both parties to make a considered decision, the optimal bankruptcy law should have both a debtor and a creditor chapter. The second system is one that is based on bank financing, where the banks are active monitors of their debtors. The debtor has no informational advantage on its creditor and cannot use its private information strategically. Here, the optimal bankruptcy system should have a creditor chapter only. Finally, in underdeveloped systems, where corporations get their financing from banks but where banks cannot efficiently monitor their debtors, the optimal bankruptcy system should have a debtor chapter only.[167]

2. *Contract Enforcement as Determinant of the Bankruptcy System*

To Yun Ayotte, judicial bankruptcy enhances the efficiency of incomplete contracts because it gives the parties, *ex-post*, the information they require to make a considered decision with respect to liquidating or reorganizing.[168] Hence, policymakers should take into consideration the quality and sophistication of the judiciary in a particular country when drafting a bankruptcy statute. More specifically, the level of creditor-friendliness in bankruptcy should increase if the country has an inefficient contract

---

[163] Elazar Berkovitch & Ronen Israel, *Optimal Bankruptcy Laws across Different Economic Systems*, 12 REV. FIN. STUD. 347, 364 (1999).

[164] *Id.* at 361.

[165] *Id.* at 363.

[166] *Id.* at 348.

[167] *Id.* at 349.

[168] ,Kenneth Ayotte & Hayong Yun, *Matching Bankruptcy Laws to Legal Environments* (2006), *available at* http://ssrn.com/abstract=613641.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

enforcement regime or if the country's judiciary is not able to distinguish viable from unviable firms.[169]

3. *A Near Sighted Justice can be Tantamount to Efficient Bankruptcy Regime*

Nosal & Bernhardt et al. go one step further. They argue that courts *should* err in determining which firms should be liquidated and which should not. An optimal justice system is not one that never errs but one with an optimal error rate that affects the incentives of good and bad entrepreneurs *ex ante*.[170]

The authors define two kinds of entrepreneur. Those with "good skills" should always be saved while those with bad skills should be liquidated.[171] If courts identify good and bad entrepreneurs, good entrepreneurs are encouraged to engage in morally hazardous activities, such as taking excessive risks and investing in negative net-present-value projects. This is so courts will always correctly identify the entrepreneurs' superior skills and will grant these entrepreneurs a second chance in order to reorganize. Conversely, bad entrepreneurs are aware that courts will always identify and liquidate their ventures upon financial distress. Hence, they will take any step in order to delay filing for bankruptcy, such as fire sales of assets or adopting other inefficient short-term strategies in order to finance their liquidity needs. A fallible court could therefore be socially desirable in order to limit the bad entrepreneur's aversion to bankruptcy and the good entrepreneur's incentives to behave sub-optimally. Moreover, a court that errs occasionally could encourage the parties to settle their contentions rather than test their claims in an unreliable court. Because a court's performance influences investor behavior *ex ante*, courts should err, at least occasionally, in order to create efficient *ex ante* incentives.[172]

II. EMPIRICAL STUDIES: THE COST OF BANKRUPTCY

In this background of raging and inconclusive policy debates, this section reviews the empirical evidence on the time, cost, and recovery rate of creditors that differing bankruptcy policies yield in order to determine which bankruptcy

---

[169] *Id.* at *4.

[170] Dan Bernhardt & Ed Nosal, *Near-Sighted Justice*, 59 J. FIN. 2655 (2004).

[171] *Id.* at 2656.

[172] *Id.* at 2657.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

rules create superior results. The aim is to test whether the contentions some scholars have against judicial bankruptcy that includes judicial bargaining[173] are supported empirically. The Bankruptcy Code is a good example of a judicial bankruptcy system involving judicial bargaining. Studies show that the United States bankruptcy regime is relatively inexpensive, at least in large bankruptcy cases.[174] The cost of financial, rather than economic, distress is negligible.

Furthermore, auction bankruptcy does not outperform bankruptcy bargaining. The direct costs of bankruptcy auctions in Switzerland are similar to those in the United States.[175] Although Swiss bankruptcies are more prompt, which could imply lower indirect costs, secured and unsecured creditors in the United States recover more than their Swiss counterparts. More importantly, the practice of bankruptcy in Switzerland demonstrates that auctions do not always preserve the APR as the proponents of auction bankruptcy claim. Over time, the efficiency of the United States bankruptcy reorganization regime has improved. Data for the last twenty years reveal higher confirmation rates and lower dismissal or confirmation delays.[176] Data from Japan show that reorganizations are beneficial to creditors for confirmation rates as low as thirty percent.[177] In 1995, 29.5 percent of bankruptcy cases were confirmed in the United States, and nothing indicates that this upward confirmation trend is not persistent or sustainable.[178] Data also show that the risk, or incidences, of forum-shopping did not increase with the adoption of the 1978 Bankruptcy Code; even with the Code's more lax rules regarding displacing management in reorganizations or to its eligibility criteria for filing for bankruptcy.[179] Finally, new empirical data highlight the redistributive effect of contract bankruptcy. Opting out of bankruptcy makes the alternative contractual procedure less equitable and more expensive than the collective procedure under the current system.[180]

---

[173] *See supra* Part I.

[174] *See* Gregor Andrade & Steven N Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. FIN. 1443 (1998).

[175] Karin S. Thorburn, *Bankruptcy Auctions: Costs, Debt Recovery and Firm Survival*, 58 J. FIN. ECON. 337, 339 (2000).

[176] *See infra* II.C.1.

[177] Theodore Eisenberg & Shoichi Tagashira, *Should We Abolish Chapter 11? The Evidence from Japan*, 33 J. LEGAL STUD. 111, 113 (1994).

[178] *See infra* Figure 2.

[179] *See infra* II.D.

[180] *See infra* II.E.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

A. Bankruptcy Proceedings are Not Costly

The costs of large bankruptcy procedures under the current Bankruptcy Code are relatively low. In one of the more frequently cited papers on this issue, Lawrence Weiss studied thirty-seven New York Stock Exchange and American Stock Exchange firms that declared bankruptcy from November 1979 to December 1986.[181] The author estimates that bankruptcy's direct costs average 3.1 percent of the book value of debt plus the market value of equity, calculated at the end of the fiscal year preceding bankruptcy.[182]

Beyond direct costs, Professors Andrade and Kaplan investigate whether the poor performance of insolvent firms is due to the inefficiencies of the traditional bankruptcy procedure itself or to the other factors that made these firms insolvent in the first place.[183] Most empirical research had samples that included insolvent firms with negative operating income. Hence, the observed firms had questionable going-concern value and could have been distressed both financially and economically.[184] To isolate the true cost of bankruptcy, that is the cost of financial, not economic distress, the authors selected thirty-one highly leveraged firms with positive operating margins during the year that preceding insolvency.[185] Frequently, these firms have higher than industry average operating income and face only a liability problem, which they accumulate through high-leverage-transactions ("HLT").[186] The authors noticed that the operating and net-cash flow margins of these distressed firms increased immediately following the HLT, declined when the firms become financially distressed and during financial distress, then increased again to levels that are close to their pre-HLT levels after financial distress is resolved.[187] The authors identify three costs of financial distress: (1) some firms dramatically decrease their capital expenditure; (2) some firms are obliged to fire sell their assets in order to fund their liquidity needs; and (3) others inefficiently delay filing for chapter 11.[188] A number of firms in the study have benefited from financial distress for they were pushed to cut costs

---

181 Weiss, *supra* note 90, at 287.

182 *Id.* at 289.

183 *See generally* Andrade & Kaplan, *supra* note 174..

184 *Id.* at 1444. Firms that are economically distressed are firms whose business model is failing. Firms that are only financially distressed, however, are firm with a viable business model but where a mismatch of cash and debt maturity causes them to go bankrupt. *Id.*

185 *Id.*

186 *Id.* at 1445.

187 *Id.*

188 *Id.*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

and to hire new managers. More importantly, the study shows that most of the costs of financial distress takes place when firms become insolvent but *before* they enter chapter 11.[189] Chapter 11, as such, is neither so costly nor so inefficient as to warrant radical change.

In *Survey Evidence on Business Bankruptcy*,[190] Professor Michelle White provides a synthesis of important empirical studies that investigate the characteristics of insolvent firms and how their stakeholders fare in bankruptcy. The studies were done at different times, ranging from the date the Bankruptcy Code was adopted, until the mid 1990s. Table 2 summarizes these results.

---

[189] *Id.* at 1445–46.

[190] Michelle J. White, *Survey Evidence on Business Bankruptcy*, *in* CORPORATE BANKRUPTCY, ECONOMIC AND LEGAL PERSPECTIVES 298 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Table 2: Characteristics of Firms in Bankruptcy[191]

	Small Chapter 7	**Small Chapter 11**	**Large Chapter 11**
Assets	$10,000 (Ames)	$257,000 (Ames)	$222,000,000 (Weiss)
	$437,000 (White)	$1,400,000 (White)	$123,000,000 (Hotchkiss)
		$1,100,000 (LoPucki)	$285,000,000 (Hotchkiss)
		$5,000,000 (Flynn)	
Liabilities	$72,000 (Ames)	$357,000 (Ames)	$313,000,000 (E/M/R)
	$710,000 (White)	$1,900,000 (White)	
		$1,000,000 (LoPucki)	
		$5,000,000 (Flynn)	
Secured Liabilities	$10,000 (Ames)	$154,000 (Ames)	
	$182,000 (White)	$893,000 (White)	
Liabilities/ Assets	1.6 (White)	1.4 (White)	0.77 (Weiss)
	7.2 (Ames)	1.4 (Ames)	2.5 (Hotchkiss)
		0.93 (LoPucki)	1.45 (Hotchkiss)
Secured Liabilities/ Assets	0.42 (White)	0.64 (White)	
	1.0 (Ames)	0.60 (Ames)	
Time in Bankruptcy		10 mo. (LoPucki)	2.5 years (Weiss)

191 *Id.* at 299. Source: Michelle J. White, Survey Evidence on Business Bankruptcy. (F/T) indicates Franks and Torous (1989), (L/W) indicates LoPucki and Whitford (1990) or (1993). (E/M/R) indicates Eberhard, Moore, and Roenfeldt (1990), (J-C) indicates Jensen Cocklin (1992). (Ames) indicates N. Ames et al. (1983), (LoPucki) indicates his study of 1983, (Weiss) indicates his study of 1990. The first figure given for Hotchkiss is for her large sample and the second is for her small sample.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

		2.0 years (Flynn)	3.7 years (F/T)
		1.8 years (J-C)	2.1 years (E/M/R)
			1.6 years (Flynn)
Probability of Adopting a Plan		0.41-0.47 (White)	0.86 (Weiss)
		0.26 (LoPucki)	0.77 (E/M/R)
		0.25-0.30 (Flynn)	
		0.17 (J-C)	
Payoff Rate to Unsecured Creditors	0.04 (White)	0.34 (White)	0.49 (L/W)
		0.52 (Flynn)	0.53 (Weiss)
		0.10-0.30 (J-C)	0.69 (E/M/R)
Direct Cost of Bankruptcy			0.031 of assets (Weiss)
Probability of Deviation from APR			0.78 (F/T)
			0.23 (E/M/R)
			0.79 (Weiss)
Probability that Chapter 11 Plans are fulfilled		0.35 (J-C)	
Probability of further restructuring			0.33 (Hotchkiss)
			0.33 (L/W)

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

B. Auction Bankruptcy is Not More Efficient

Although it does not involve bargaining among stakeholders, auction bankruptcy is not cheaper than traditional bankruptcy. Moreover, self-dealing and APR violations are possible in auctions. In short, studies that investigate the performance of bankruptcy regimes based on auctioning the debtor do not conclusively find that such systems outperform traditional bankruptcy.

1. Swedish Auction Bankruptcies

Karin Thorburn studies 263 small firm bankruptcies in Sweden from January 1, 1988 to December 31, 1991 and compares the companies' survival rates, creditors' recovery, and bankruptcy costs with those scored under the Bankruptcy Code.[192] Since data on the chapter 11 bankruptcies tend to focus exclusively on larger companies, the author includes in her analysis control variables[193] in order to enhance the comparability of the data.[194] The Swedish bankruptcy code has no effective reorganization provisions. The managers and shareholders of bankrupt companies are immediately displaced and are replaced by a court appointed trustee. Failing companies are auctioned on the market on a going-concern or piecemeal basis for cash that is then divided among stakeholders following the APR.[195] The country's bankruptcy rules and bankruptcy outcomes provide an ideal laboratory for the proponents of an auction theory.

Thorburn reports a seventy-five percent survival rate (auction of companies as a going concern) that is similar to the percentage that Professor White reports with respect to the survival rate of small companies in chapter 11 proceedings.[196] The author estimates the average direct cost of Swedish bankruptcy auctions to be 6.4 percent across the selected sample of firms and 3.7 percent for the largest ones.[197] The latter estimate is close to Weiss's[198]

---

192 Karin S. Thorburn, *Bankruptcy Auctions: Costs, Debt Recovery, and Firm Survival*, 58 J. FIN. ECON. 337 (2000).

193 The variables reflect firm size and financing and ownership structures, among other things.

194 The author also controls for industry distress, asset uniqueness, and operating profitability relative to the filing firm's competitors. *Id.* at 338.

195 *Id.* at 340–43.

196 *Id.* at 339 (citing Michelle J. White, *Bankruptcy Liquidation and Reorganization*, *in* HANDBOOK OF MODERN FINANCE 35-1 (Dennis E. Logue, Ed., 1984)).

197 This is in percent of pre-filing book value of assets. *Id.*

198 Weiss, *supra* note 90, at 286.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

and Betker's[199] estimations of the direct costs of bankruptcy for large public United States companies.

However, Swedish bankruptcy auctions take a much shorter time than United States bankruptcy proceedings. Proceedings in Sweden take on average two months versus two years in the United States.[200] Bankruptcy's indirect costs seem to be much smaller in Sweden than in the United States. The author reports an overall thirty-five percent recovery rate for creditors in Sweden on average: a thirty-nine percent recovery rate when the firm is sold as a going concern and twenty-seven percent for piecemeal liquidations.[201] Secured creditors recovered on average sixty-nine percent of their claims and unsecured creditors only two percent.[202]

Though the different methodologies make the data difficult to compare, Thorburn's recovery estimates are: (1) lower than the forty-one percent median recovery rate of creditors under chapter 11 as reported by Franks and Torous;[203] (2) lower than the four percent average recovery rate of unsecured creditors in small Chapter 7 bankruptcies as reported by Professor White;[204] and (3) lower than the hundred percent recovery rate that unsecured creditors received in fifty percent of small chapter 11 cases as reported by Professor LoPucki.[205] These numbers are significant because proponents of auctions are strong believers that bankruptcy is a creditor distribution question. These scholars care about indirect costs in bankruptcy mainly because they lower creditor returns. Although comparatively more prompt, auction bankruptcy in Sweden seems to provide creditors with lower recovery rates than bankruptcy bargaining provides creditors in the United States, irrespective of the higher indirect costs that the latter entails. More importantly, Thorburn notes that creditors recover more when the original owner buys his own business in the auction with financing from the same creditor bank. This, the author argues,

---

199 Brian L. Betker, *The Administrative Costs of Debt Restructurings: Some Recent Evidence*, 26 FIN. MGMT. 56 (1997).

200 *Id.* at 340.

201 *Id.*

202 *Id.* Note that the recovery rate is very unbalanced in favor of secured creditors: the median recovery rate for secured creditors is eighty-two percent and the median recovery rate for unsecured creditors is zero percent.

203 Julian R. Franks & Walter N. Torous, *A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganizations*, 35 J. FIN. ECON. 349 (1994).

204 White, *supra* note 190, at 300.

205 Lynn M. LoPucki, *The Debtor in Full Control–Systems Failure Under Chapter 11 of the Bankruptcy Code?* 57 AM. BANKR. L.J. 99, 101 (1983).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

could reflect the existence of private information about the firm's value which the old owners and the main bank use to their advantage.[206]

Per Stromberg investigates this last phenomenon further.[207] In a study of 205 bankrupt Swedish firms from 1988 to 1991, the author finds that sale-backs are common in Swedish bankruptcy auctions.[208] The author notes two reasons for such occurrences. First, sales-back are common when firms have illiquid assets and face the prospect of inefficient, fire-sale liquidations. In this context, the author shows how, in an auction bankruptcy regime, sale-backs are tantamount to a debt restructuring, where management maintains control of the failed business. More importantly, the author reports a higher incidence of sale-backs when the bank "bears a disproportionate amount of downside risk from a liquidation."[209] This is true in situations where the bank is the senior creditor and the debtor's liquidation value barely covers the bank's loan. When the sale-back price is lower than the firm's going-concern market value, the APR is violated because the old owner retains a surplus at the expense of junior creditors who should normally be paid first. The study shows how cash auctions in bankruptcy do not necessarily correct what critics argue are inherent limitations of corporate reorganization procedures. Individual interests can still push the debtor toward inefficient outcomes, which are different from the ones pure market impulses would provide, for example, continuing the exploitation of the business by the original owners rather than liquidating the venture.[210] Moreover, the most appealing argument for auctions is the fact that following APR they allow the division of the proceeds among stakeholders unequivocally. The data from Sweden show that this is not necessarily the case.[211]

2. *Chapter 7 Costs versus Chapter 11 Costs*

In a study of over 300 bankruptcy cases from the Arizona and New York federal bankruptcy courts from 1995 to 2001,[212] Arturo Bris measures the costs

---

206 Thorburn, *supra* note 192, at 340.

207 Per Stromberg, *Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and Tests*, 55 J. FIN. 2641 (2000).

208 *Id.* at 2644.

209 *Id.* at 2644–45.

210 *Id.*

211 *Id.* at 2645.

212 The sample represents the entire population of corporate bankruptcy cases in these courts.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

of chapter 7 auctions and chapter 11 bargaining.[213] Chapter 7 liquidations are similar in nature to Swedish auction bankruptcies. If Thorburn's claim is universal, that auctions are superior to bargaining, then chapter 7 cases in the United States should fair better than chapter 11 cases with respect to both direct and indirect costs. The authors use rigorous econometric tools in order to control for selection bias, companies entering chapter 7 might be financially worse off than those entering chapter 11, and to guarantee the comparability of the two sub-samples. They use three different methods to measure costs: (1) the change in the value of the estate during bankruptcy; (2) the time spent in bankruptcy; and (3) the recovery rates of creditors.[214]

The study shows that bankruptcy costs are heterogeneous and very sensitive to the method of calculation that is adopted.[215] On average, chapter 7 procedures are more expensive than chapter 11 procedures. After controlling for endogeneity, chapter 7 cases take as long as chapter 11 cases, approximately two years.[216] Direct costs are more important in chapter 7 cases where bankruptcy professionals, such as lawyers, accountants, and trustees, receive the largest part of the estate's post-bankruptcy value. In terms of pre-bankruptcy ratios, chapter 7 is not significantly more expensive than chapter 11. However, in terms of post-bankruptcy ratios, chapter 7 is significantly more expensive.[217]

Creditors' recovery rates are much higher under chapter 11 than under chapter 7. In around ninety-five percent of chapter 7 cases, unsecured creditors received zero recovery. To the contrary, in chapter 11 it is common for secured creditors to be paid back in full.[218] This is also true of unsecured

---

[213] Arturo Bris, Ivo Welch, & Ning Zhu, *The Costs of Bankruptcy Chapter 7 Cash Auctions vs. Chapter 11 Bargaining* (EFA 2004 Maastricht Meetings Paper No. 5155 (2004)), *available at* http://ssrn.com/abstract=556930.

[214] *Id.*.

[215] Estimates vary depending on whether the researcher used "at-bankruptcy declared values" or "end-of-bankruptcy declared values," whether estimates that management provides upon filing is credible or not, and whether the researcher reports means or medians. *Id.* Therefore, researchers should hence be careful when formulating general statements with respect to bankruptcy's cost (i.e. claiming that bankruptcy costs are modest in general, etc.).

[216] *Id.* at *1. Chapter 11 cases later converted to chapter 7 did not take longer time than pure chapter 7 cases. *Id.* at 11.

[217] *Id.* at *1.

[218] Under chapter 11, total creditor recovery equaled thirty percent for bankruptcies with less than one million dollars in assets and 70-90% for those with more than ten million dollars. Unsecured creditors received 30-40% for bankruptcies with less than five million dollars in assets and 40-60% for those with more than five million dollars. *Id.* at *16.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

creditors in twenty-three percent of the cases. On average, unsecured creditors receive a forty percent recovery rate in chapter 11 cases.[219] These differences in recovery rates between liquidation and reorganization are not attributable to the level of indebtedness of the debtor or to the debtor's size.

Chapter 7 performs unequivocally better than chapter 11 on one particular front: the probability of violating the APR is higher under chapter 11 than under Chapter 7. The APR was strictly enforced in all chapter 7 cases but only in eighty-eight percent of chapter 11 cases.[220] The study finds that the identity of the judge who is supervising the bankruptcy case, the relative size of secure credit to total debt, the duration of the case, the number of creditors, the number of unsecured creditors, legal expenses, and the percentage of ownership of managers, are all factors that determine the probability of violating the APR in reorganization proceedings.[221]

C. *Low Confirmation Rates and Lower Consummation Rate: A Sign of Inefficiency?*

A debtor that spends time trying unsuccessfully to reorganize, wastes assets that could have gone to its creditors if it were immediately liquidated. When confirmation rates are too low, the cost of reorganization, on average, could exceed its benefits and judicial bargaining in bankruptcy becomes inefficient.

1. *Confirmation Rates in the United States*

The Fee Information and Collection System ("FICS") database maintained by the Executive Office for U.S. Trustees ("EOUST") shows a confirmation rate of 25.84 percent for chapter 11 cases that are filed from 1/1989 to 12/1995 (figure 1 below). The data show an increase in confirmation rate with time, starting as low as 13.3 percent in 1983 but reaching 29.5 percent in 1995 (figure 2 below).[222]

---

[219] *Id.*

[220] *Id.* at *15.

[221] *Id.* at *1–2.

[222] Gordon Bermant & Ed Flynn, Bankruptcy by the Numbers, *available at* http://www.usdoj.gov/ust/eo/public_affairs/articles/docs/abi98febnumbers.pdf (March 17, 2007).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Figure 1

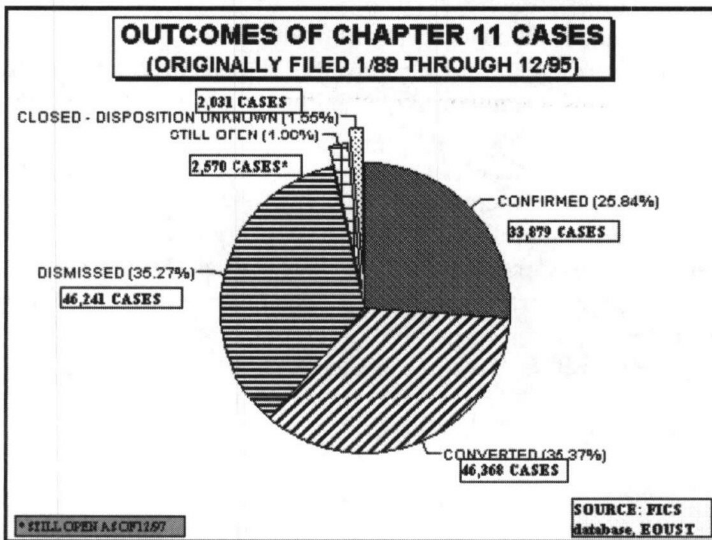
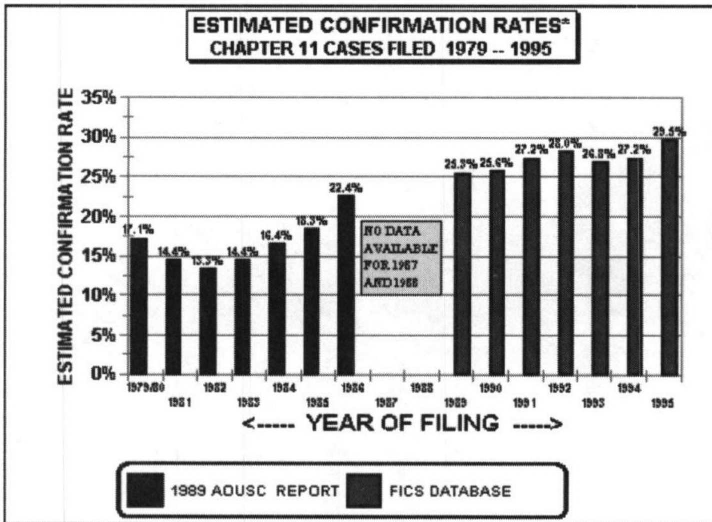


Figure 2



Source: Bermant & Flynn, Bankruptcy by the Numbers

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The time courts take to confirm or dismiss chapter 11 cases is also decreasing with time. Figure 3 (below) shows the 20th, 50th, and 80th percentiles of the distribution intervals from the filing of the reorganization case to the confirmation of the plan by the competent court. Cases that typically take the most time to confirm required, on average 696 days in 1997 instead of the 1107 days that were required in 1989. This represents a thirty-seven percent decrease in time. Intervals in the 20th and the 50th percentiles have decreased eighteen percent and twenty-seven percent, respectively, during the same period. Similarly, cases that typically take the most time to be dismissed required on average 462 days in 1997 instead of the 783 days that were required in 1989 (see figure 4 below). This represents a forty-one percent decrease in time. Intervals in the 20th and 50th percentiles have decreased forty-four percent and forty-seven percent, respectively, during the same period (figure 4).[223]

---

[223] *Id.* at ¶ V.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Figure 3

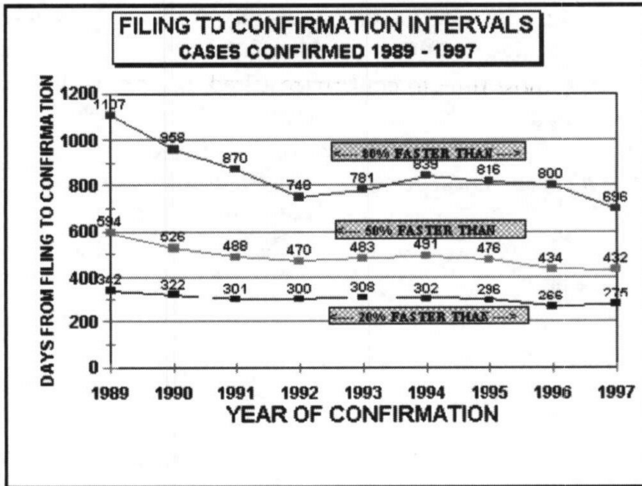
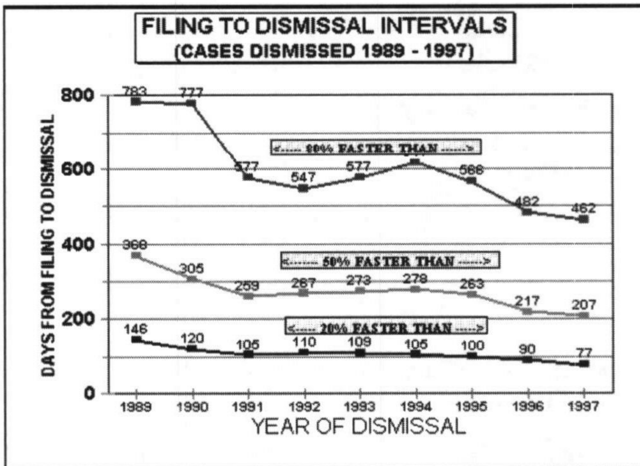


Figure 4



Source: Bermant & Flynn, Bankruptcy by the Numbers

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

While information with respect to confirmation rates is available for reorganizations, there is minimal research that tracks how reorganized firms fare after emerging from bankruptcy. In a study of all reorganization cases that were filed in the Southern District of New York Poughkeepsie from 1980 to 1989, Susan Jensen Conklin reports that 17.31 percent of chapter 11 plans were confirmed and that only ten percent of these were consummated.[224] If one subtracts liquidation plans, the debtor survived as a legal entity in only 6.5 percent of the reorganization cases.[225] The FICS database shows a continuous improvement in confirmation rates and delays. Because Susan Jensen Conklin's data are more than seventeen years old, one should examine these results with caution.[226]

Table 3: Do Confirmed Chapter 11 Plans Consummate?

1. Percentage of Cases that Filed for Reorganization in the District: 3.84%
2. Percentage of Reorganization Cases (RC) that were Confirmed: 17.31%
3. Percentage of RC with Confirmed Liquidation Plans: 26%
4. Percentage of Confirmed Cases that were Converted to Chapter 7 or Dismissed: 22%
5. Percentage of Confirmed Cases that were Consummated: 58%
6. Total Percentage of Consummated Plans (from all sample): 58% * 17.31% = 10%.
7. Percentage of Debtors Who Survived as Legal Entity: 10% * (% liquidation plan consummated) = 6.5%

Source: Conklin, Do Confirmed Plan Consummate?

The increase in confirmation rate and the shortening of confirmation delays are difficult to interpret from an efficiency perspective. Professor Lynn LoPucki accuses venue competition over big bankruptcy cases of corrupting

[224] Susan Jensen Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*, 97 COM. L. J. 297 (1992).

[225] *Id.* at 325.

[226] *Id.* at 317.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

bankruptcy judges and pushing them to be more complacent with debtors.[227] The debtor's increased ability to remove its creditors from the basic protections of the Bankruptcy Code might explain the higher confirmation rates and shorter delays over time. Among the evidence that corroborates LoPucki's view is the high average of repeat bankruptcies among debtors that recently emerged from financial distress and confirmed reorganization plans in Delaware's bankruptcy courts.[228]

While LoPucki's thesis potentially explains the phenomenon of higher confirmation rates and shorter court delays, other explanations can also validly explain these results. For example, bankruptcy courts could be learning by doing more of the same. After nearly thirty years of practice, advances in technology, investment in infrastructure, and improvements in case management techniques, courts are now more capable of distinguishing good reorganization candidates from bad. In addition, the stigma of bankruptcy has disappeared. This is prompting investors and managers to file for bankruptcy earlier when the company's chances to survive are stronger. If this reasoning is correct, the efficiency of the current bankruptcy system could continue to improve over time without the need for radical bankruptcy reform with consequences difficult to predict. In this context, a more relevant query is to determine the confirmation-rate threshold that makes the benefits of bargaining in bankruptcy worth its costs.

2. *What is the Efficient Confirmation Threshold?*

Professors Theodore Eisenberg and Shoichi Tagashira address this question by researching whether creditors as a group are net winners or net losers in bankruptcy reorganizations.[229] The laboratory is Japan where the authors benefit from the national data-gathering effort undertaken by the Research Group on Empirical Study of Composition Proceedings.[230] The data cover all composition cases that were filed in Japan from 1982 to 1987. All districts

---

[227] LYNN M. LOPUCKI, COURTING FAILURE, HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 137–83 (2005).

[228] *Id.* at 97–122.

[229] Theodore Eisenberg & Shoichi Tagashira, *Should we abolish Chapter 11? The Evidence from Japan*, 33 J. LEGAL STUD. 111 (1994).

[230] The composition procedure is the Japanese equivalent of chapter 11 reorganization under the U.S. Bankruptcy Code that was in force at the time of Eisenberg and Tagashira's study.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

with a large population are included. The debtors are mainly small and mid-sized firms in financial distress.[231]

The authors' method is based on the following reasoning. The best interest test that is applicable under the Japanese reorganization regime requires that creditors receive in reorganization at least what they would have received if the debtor was immediately liquidated. This problem is most acute when the debtor fails to confirm a reorganization plan and the court converts the procedure to liquidation. Here, the creditors are worse off. If the debtor was immediately liquidated upon filing for bankruptcy there would have been sizable cost savings. The authors then measure creditors' gains in successful reorganization cases and creditors' losses in failed reorganization attempts to determine the minimal confirmation rate that is required for reorganization procedures to be worth their costs. A very low confirmation rate would give more weight to the claim that reorganization is inefficient and should be replaced by simpler and faster auction-like procedures. To the contrary, a high confirmation rate makes it more probable that reorganization is a worthy and a viable system.[232]

The authors determine that a thirty percent confirmation rate in reorganizations is enough to yield a gain to creditors over an all liquidation regime.[233] This number is very close to the 1997 29.5 percent confirmation rate in the United States.[234] Although administrative costs absorb some of the creditors' gains, the authors note the persistence of a substantial aggregate going-concern surplus in reorganized debtors.[235] Hence, judicial reorganization of small and mid-sized businesses is a viable option and even more so for larger companies. Abolishing Chapter 11 could hurt rather than cure creditors' problems in bankruptcy.

D. APR Violations are More Common Under Chapter 11: Is Chapter 11 Exacerbating the Problem of Forum-Shopping?

Empirical studies of chapter 11 cases consistently show a deviation from the APR.[236] This, coupled with the debtor-in-possession rule ("DIP") that the

---

[231] *Id.* at 120.

[232] *Id.* at 125.

[233] *Id.* at 113.

[234] *See supra* Figure 2.

[235] *Id.*

[236] *See, e.g.*, Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747 (1989); Stuart C. Gilson, *Transaction Costs and Capital Structure Choice:*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Bankruptcy Code has adopted as a general principle in reorganizations, could open the door to forum shopping. Debtors could choose to file for Chapter 11 in order to benefit from the protections and privileges it provides without regard to whether their financial situations genuinely necessitate filing for bankruptcy. Indeed, the Bankruptcy Code does not require the debtor to be insolvent in order to file for reorganization.[237] If forum shopping is on the rise, one should witness a sharp increase in bankruptcy filings starting from 1978, which is when Congress adopted the current Bankruptcy Code.

1. Comparing Data from Before and After 1978

Michael Bradley and Michael Rosenzweig address this question by studying the frequency of public company voluntary bankruptcy filings from 1962 to 1989.[238] In the process, the authors collect information on the financial characteristics of distressed firms and on stakeholders' recoveries both before and after the adoption of the Bankruptcy Code. To the authors, the 1978 reform subscribed to the view that financial distress is an *exogenous* event that should be corrected by relaxing the requirements for filing for reorganization and by encouraging debtors to seek bankruptcy protection earlier. By doing so, the reform made the bankruptcy decision *endogenous* and similar to any other financial tool available to managers to score benefits.[239]

The study yields empirical evidence that Bradley and Rosenzweig interpret to their advantage. First, the authors find that failing firms are leveraged more after 1978 than before that year. After 1978, companies have higher debt to asset ratios and more long-term debentures. With the adoption of the Bankruptcy Code, managers fear the adverse consequences of financial distress less and are more inclined to take risks. More importantly, the authors note a dramatic increase in voluntary filings for reorganization after 1978. Meanwhile, companies entering bankruptcy are more financially sound and less frequently de-listed in the year preceding financial distress. General economic conditions rarely predict the advent of these firms' bankruptcy.[240]

Evidence from Financially Distressed Firms, 52 J. FIN. 161 (1997); Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990).

[237] 11 U.S.C. § 109.

[238] Michael Bradley & Michael Rosenzweig, *The Untenable Case For Chapter 11*, 101 YALE L.J. 1043 (1992).

[239] *Id.* at 1047–48.

[240] *Id.* at 1049.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Second, the authors argue that stockholders and bondholders fare worse under the 1978 Bankruptcy Code than under the Chandler Act. There are also more incidents of corporate insiders selling stocks two years before the company's failure and increases in default premiums. The only parties that benefit from Chapter 11 seem to be professionals, e.g. attorneys' and accountants' fees, and managers who use bankruptcy as another defensive device to keep control of their companies.[241]

2. *Reinterpreting the Data: Warren's Reply*

In a strongly worded reply, Professor Elizabeth Warren questions Bradley's and Rosenzweig's interpretation and the integrity of their data collection.[242] Warren notes the differences in the governance dynamics that characterize the bankruptcies of privately held and publicly held companies. In small and medium enterprises, the conflict of interest between owners and managers is weak. This has different implications with respect to bankruptcy policy. The number of publicly traded companies filing for bankruptcy during the period that Bradley and Rosenzweig investigated represents only one percent of all chapter 11 reorganizations that were filed during that period. Yet, the authors propose a solution that is applicable to all bankruptcies irrespective of the limitations of their biased and highly selective sample.[243] More importantly, Warren notes that many bankruptcy cases were conveniently dropped out of Bradley's and Rosenzweig's data without a valid reason.[244] Statistically, there is not a significant difference between the number of public companies filing for bankruptcy in the 1970s and those filing in the 1980s. General economic conditions prevalent during the 1980s could stand behind some of the observed differences, such as the inflation rates in the 1980s, leverage buyouts, junk bond markets, and deregulation.[245] Moreover, empirical studies with respect to manager turnover in public company reorganizations show that, if anything, managers post-1978 face much greater risk of losing their jobs than their pre-1978 counterparts.[246] Post-1978, manager turnover rate is seventy to ninety

---

241 *Id.*

242 Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L. J. 437 (1992).

243 *Id.* at 440–41.

244 *Id.* at 455.

245 *Id.* at 444–46.

246 Warren mentions two studies with respect to management turnover of large publicly listed companies in pre-Code bankruptcies. One study investigates eleven railroad companies that filed for bankruptcy from 1933 to 1955. The study shows an annual CEO turnover rate of eight percent. Railroad companies that were not bankrupt had a nine percent CEO turnover rate. The second study investigates fifty-two firms that filed for

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

percent while the rate was only sixteen to forty-one percent pre-Code. This is partly due to the fact that the appointment of a trustee under Chapter X of the Chandler Act did not necessarily translate into dismissing old management.[247] Finally, filing for bankruptcy protection when the firm is solvent is not necessarily a bad sign. It might, to the contrary, highlight the success of the 1978 Bankruptcy Code in encouraging managers to file early when saving the failing business is still feasible and without fearing the loss of their jobs.[248] Encouraging such an early fix might warrant relaxing the Bankruptcy Code's filing rules.

E. *Contract Bankruptcy would be Re-Distributional and Costly*

Finally, freedom of contracts in bankruptcy is hard to apply in practice. If it were, the bankruptcy regime would be prohibitively costly. To put the contractual theory to the test, Professors Elizabeth Warren and Jay Westbrook measure empirically the propensities of a contractual bankruptcy regime to redistribute wealth among stakeholders.[249] The authors undertake this task by collecting information from thousands of failed businesses that filed for bankruptcy in twenty-three federal districts in 1994 and by dissecting the anatomy of a typical debtor. Specifically, the authors researched the types of claims that creditors declare in business bankruptcy, their numbers, and their individual and collective dollar value.[250] Bankruptcy is redistributive if its costs are shifted from the debtor and the contracting parties to other non-adjusting creditors. Non-adjusting creditors are those who do not take part voluntarily to the bankruptcy contract[251] or those whose stakes are too small to warrant adjusting their interests to the new risks that the bankruptcy contract entails.[252] The more non-adjusting creditors for one debtor, the more

bankruptcy from 1969 to 1973. Only fourteen percent of these firms' managers lost their jobs one year after the filing. *Id.* at 453.

247 *Id.* at 449–51.

248 *Id.* at 463.

249 Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005).

250 *Id.* at 1202.

251 Warren and Westbrook classify non-adjusting creditors into five groups: tort creditors, utilities, taxing authorities, employees, and non-trade natural persons. *Id.* at 1226–35.

252 Creditors that are too small to adjust are voluntary, sometime sophisticated, creditors who face costs—in case they monitor their debtor—that are far superior to the benefits they might gain from such monitoring. For example, the creditor adjusting their claims to a new bankruptcy contract that their debtor concluded with a third party (e.g., increase the interest rate they charge in line with their particular circumstances and risk preferences). *Id.* at 1240.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

redistributive, inequitable, and hence, inefficient is contractual bankruptcy. The total number of creditors that a debtor reports on average is also important because it says something with respect to the feasibility of contract bankruptcy. The greater the number of creditors, the more difficult it is to coordinate and negotiate a contract to which everyone subscribes, and the higher the transaction costs.[253]

The authors' findings are damning for contractual bankruptcy models. The study shows that four out of every five business cases list at least one non-adjusting creditor.[254] The importance of non-adjusting creditors persists over time. In 2002, the percentage of debtors listing at least one non-adjusting creditor was 76.7 percent[255] Moreover, the relative importance of non-adjusting claims with respect to other claims increased on average. In 1994, 15.2 percent of all unsecured claims were non-adjusting. In 2002, these claims constituted 35.2 percent.[256] The median claim in the authors' sample was $905.[257] For every five unsecured claims, four were less than $5,000. Using $5,000 as a threshold for small claims, eighty percent of all unsecured claims would be too small to sustain any bargaining.[258] Eighty-seven percent of all filed cases list at least one small claim.[259] Finally, one third of the cases in the sample have twenty or more unsecured claims. One case involving a ski equipment manufacturer had as many as 255 unsecured claims.[260] These numbers reflect a harsh reality: contract bankruptcy would inequitably redistribute wealth and would be very costly to implement practically.

III. EMPIRICAL CROSS-COUNTRY STUDIES: BANKRUPTCY AND THE DETERMINANTS OF FINANCIAL DEVELOPMENT

At best, the available data on the time, cost, and creditors' recovery rate do not unequivocally support the views of the opponents of the judicial bankruptcy with bargaining. This section reviews cross-country empirical evidence that studies the role of bankruptcy law in determining the supply of credit in order to determine what bankruptcy rules promote economic growth

---

253 *Id.* at 1202.
254 *Id.* at 1226.
255 *Id.* at 1337.
256 *Id.*
257 *Id.* at 1223.
258 *Id.* at 1244.
259 *Id.* at 1245.
260 *Id.* at 1251.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

and financial development. La Porta creates an index of Creditors' Rights (LLSV Creditors' Rights index) in forty-nine countries worldwide and fail to show a meaningful connection between protecting creditors and the development of liquid capital markets.[261] Djankov replicates the LLSV Creditors' Right index for 129 countries and show that protecting creditors increases the ratio of private credit to GDP.[262] Haselmann shows that collateral law is a more important determinant of private credit to GDP than bankruptcy law.[263] This article will show that all of these studies focus exclusively on the secured creditors' ability to grab the assets of their debtors rather than on bankruptcy law defined as a collective proceeding. The effect of bankruptcy law on the supply of credit and other financial development measures remains untested. Djankov attempts to study the mechanisms of "debt enforcement" in eighty-eight countries but fails to provide normative guidelines for effective bankruptcy reform.

Cross-country empirical studies should assess the law as practiced rather than the law on the books in order to yield accurate data and superior conclusions. Hypothetical case studies that are analyzed and answered by local experts provide the best results in this context. More importantly, the laws to assess are bankruptcy laws where bankruptcy is defined as a *collective* procedure. Such law is an all encompassing pot where the interests of *all* bankruptcy stakeholders, secured creditors, unsecured creditors of any kind, and equity-holders, are factored and sorted out in a process that comprehensibly and efficiently addresses financial distress. A Bankruptcy Indicator of normative value should pass this *comprehensibility* test. It is not a collateral law indicator or an indicator that measures the grab powers of secured creditors exclusively, nor is it individual provisions of a bankruptcy statute that are taken one by one and correlated to other financial indicators of efficiency.

A. *The LLSV Creditors' Right Index, Financial Development, and Legal Heritage*

Law and Finance by Professor Rafael La Porta is one of the first studies that researched the laws across a sizeable number of countries in order to test

---

[261] *See infra* III.A.

[262] *See* Simeon Djankov, Caralee McLiesh & Andrei Shleifer, *Private Credit in 129 Countries* (NBER Working Paper Series, Vol. w11078, January 2005), *available at* http://ssrn.com/abstract=652366.

[263] *See infra* III.C.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

the effects of business regulations on various financial development outcomes.[264] In this article, the authors investigate whether differences in legal protection afforded to investors explain the observed differences in the dispersion of stockownership and the liquidity of securities markets in forty-nine jurisdictions worldwide. The paper had a crucial and polarizing impact on the field of law and development with some scholars writing harsh critiques against the paper's methodology.

1. The Model and Findings

Theoretically, investors are more inclined to invest in equity and creditors are more prone to finance ventures cheaply if their rights are protected against the risk of expropriation at the hands of corporate managers or other dominant shareholders.[265] La Porta researched the corporate and bankruptcy laws of forty-nine countries around the world in order to create two indices that quantify and measure these legal protections. The first index measures shareholders' rights under corporate laws and the second, the LLSV Creditors' Right index, measures creditors' rights in bankruptcy. The LLSV Creditors' Right index is the sum of four variables: (1) whether the start of a reorganization procedure automatically stays secured creditors' enforcement rights; (2) whether secured creditors enjoy absolute priority over the proceeds of their collateral in reorganization; (3) whether management is not able to file for reorganization without the previous consent of creditors; and (4) whether management is replaced by a trustee that is appointed by the court or creditors in reorganizations.[266] The index varies from a minimum score of zero, negative answers to the four questions to a maximum score of four, positive answers to the four questions. Higher scores reflect higher creditor protection.[267] Finally, the authors recognize that countries do not write their business laws from scratch. Most countries' rules are voluntary or involuntary transplants of a few legal traditions that, with minor adaptations, are specific to every country. The authors distinguish in this respect two broad legal traditions: the civil and common law. Within civil law, the authors distinguish the French, German, and Scandinavian civil law heritage.[268]

[264] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

[265] *Id.* at 1114.

[266] *Id.* at 1134.

[267] *Id.* at 1136.

[268] *Id.* at 1115.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Table 4: LLSV Creditors' Right Index[269]

Restrictions for going into reorganization	Equals one if the reorganization procedure imposes restrictions, such as creditors' consent, to file for reorganization; equals zero if there are no such restrictions
No automatic stay on secured assets	Equals one if the reorganization procedure does not impose an automatic stay on the assets of the firm on filing the reorganization petition. Automatic stay prevents secured creditors from gaining possession of their security. It equals zero if such a restriction does exist in the law.
Secured creditors first	Equals one if secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firms. Equals zero if unsecured creditors, such as the government and workers, are given absolute priority.
Management does not stay	Equals one when an official appointed by the court, or by the creditors, is responsible for the operation of the business during reorganization. Equivalently, this variable equals one if the debtor does not keep the administration of its property pending the resolution of the reorganization process. Equals zero otherwise
Creditor rights	An index aggregating different creditor rights. The index is formed by adding 1 when (1) the country imposes restrictions, such as creditors' consent or minimum dividends to file for reorganization; (2) secured creditors are able to gain possession of their security once the reorganization petition has been approved (i.e., no automatic stay); (3) secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm; and (4) the debtor does not retain the administration of its property pending the resolution of the reorganization. The index ranges from zero to four.

269 *Id.* at 1122–25.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The authors report great variations in corporate and bankruptcy laws across jurisdictions. The differences are partially explained by legal origin. Controlling for per-capita income, countries with a common law heritage protect investors, i.e. shareholders and creditors, more than countries with a civil law heritage. French civil law in particular, provides the worst investor protection.[270] The authors find a strong correlation between ownership structure and the level of shareholder protection. Countries that are bad at protecting shareholders tend to display a pattern of concentrated ownership.[271] The LLSV Creditors' Right index does not have a similar statistically significant effect. This paper is among the first to support the idea that law determines financial development through the corporate governance system it creates and to highlight the crucial role that legal heritage plays in this respect. Companies choose capital and ownership structures in response to particular corporate and bankruptcy rules that partly are determined by the legal family to which a country belongs.[272]

2. *Critique: Ambiguity and Under-Specification in the Definition of Variable*

The paper's method drew disapprobation even from law and economics scholars. Holger Spamann provides to date the most comprehensive critique of La Porta's methodology.[273] Although Spamann focuses exclusively on La Porta's "Antidirector Rights Index" ("ADRI"), which measures the legal protection of minority shareholders, the arguments that the author provides

---

[270] *Id.* at 1129–32, 1138–40.

[271] *See also* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999). The article studies the ownership structure of large corporations in twenty-seven developed economies worldwide and finding that the Berle and Means' corporation is the exception rather than the rule. Countries that provide lower investor protection have a larger proportion of family and state owned firms. Dominant shareholders control the company in excess of their cash flow rights via elaborate ownership schemes such as pyramidal structures and special voting rules.

[272] *Id.* at 1152. In an elaborate economic model, Professor Lucian Bebchuk highlights the role of private benefits of control as determinant of ownership structures in a particular jurisdiction. When private benefits of control are sizeable, a controlling block of equity stocks is sold at a premium. The original owner of a company that is going public fares better if she keeps a lock on control and transfers it via a private sale for a higher price instead of leaving it up for grab by another investor. Professor Bebchuk's model predicts concentrated ownership and complex arrangements that aim to separate shareholders' corporate cash and voting rights in jurisdictions where private benefits of control are high. *See*, Lucian Arye Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control (Harvard Law and Economics Discussion Paper No. 260 (1999)), *available at* http://ssrn.com/abstract=168990.

[273] Holger Spamann, On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-Director Rights Index' under Consistent Coding (Harvard Law School John M. Olin Center Discussion Paper No. 7 (2006)), *available at* http://ssrn.com/abstract=894301.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

easily can be extended to the LLSV Creditors' Right index. The author recodes the ADRI for La Porta's sample countries with input from local experts and without changing the original variable definitions. Under "consistent coding," Spamann finds that the ADRI is neither a statistically significant predictor of stock market liquidity nor distributed significantly among countries with different legal heritage.[274]

The author deplores the ambiguity and under-specification of La Porta's variable definitions that open the door to non-transparent, subjective, and inconsistent coding. Take, for example, the second indicator that is part of the LLSV Creditors' Right index: "management does not stay."[275] The indicator "equals one when an official appointed by the court, or by the creditors, is responsible for the operation of the business during reorganization. Equivalently, this variable equals one if the debtor does not keep the administration of its property pending the resolution of the reorganization process. [It] equals zero otherwise."[276] What if a particular country has two reorganization procedures for business companies such as Japan,[277] for example, where one procedure automatically displaces management while the other does not? The authors can always pick one procedure and drop the other. However, in the absence of clearly defined specifications to that effect, the reader cannot be sure that the same objective criterion was used in coding the answers of another country that presents a similar issue. Moreover, how should one code this indicator if old management and the court-appointed trustee manage the estate's assets concomitantly such as in Belgium?[278]

Similarly, take the third indicator: "secured creditors first."[279] It "equals one if secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm. [It] [e]quals zero if nonsecured creditors, such as the government and workers, are given absolute priority."[280] What if secured creditors are paid before the government for debtor's income taxes but after the municipality for due real-estate taxes? The

274 *Id.* at 1.

275 *See*, *supra* note 270.

276 La Porta et al., *supra* note 265, at 1123.

277 *See* Kazuki Okada & Shinsuke Kobayashi, *Japan*, *in* GETTING THE DEAL THROUGH: INSOLVENCY & RESTRUCTURING IN 43 JURISDICTIONS WORLDWIDE 206, 208–99 (Bruce Leonard ed., Law Business Research 2005).

278 *See* Ivan Peeters & Cédric Alter, *Belgium*, *in* GETTING THE DEAL THROUGH: INSOLVENCY & RESTRUCTURING IN 43 JURISDICTIONS WORLDWIDE 41, 43 (Bruce Leonard ed., Law Business Research 2005).

279 *See supra* note 270.

280 La Porta et al., *supra* note 265, at 1123.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

ambiguity and the under-specification in the variable definition stem in part from the difficulties to understand the laws of a large number of foreign countries, the complexities involved in distinguishing laws on the book from law as effectively applied, and the intricacies of condensing rules into quantitative data.[281] Take for example the "no automatic stay on secured assets" indicator. It is equal to "one if the reorganization procedure does not impose an automatic stay on the assets of the firm upon filing the reorganization petition—and zero otherwise."[282] While an automatic stay is imposed in the United States immediately upon filing for reorganization, such a stay is only imposed in France upon the issuance, many days later, of a court order accepting the bankruptcy petition. In practice, however, French lawyers always ask the court to issue an injunction that stays all enforcement actions until the final bankruptcy order is granted or rejected. French courts typically grant such injunction upon filing.[283] Without explicit coding rules that would take this fact into consideration, the law on the books is misleading. Legal concepts that look different to the eyes of the non-expert could in fact be functionally equivalent.

B. LLSV Creditors' Right Index and the Determinants of Private Credit

Beyond reporting higher scores on the LLSV Creditors' Right Index for common law countries, La Porta et al. do not provide any normative theory with respect to the effects of stronger creditor protection on financial development, such as on the supply of private credit.[284] Djankov et al. address this question by testing two relevant theories.[285] The first focuses on the ease with which creditors can obtain information about their debtor's credit worthiness in order to avoid lemons *ex ante*.[286] The second argues that private credit is a function of the ease with which creditors can grab their collateral or take over the management of the debtor in order to force the repayment of their loans *ex post*.[287] To investigate empirically the complementary effects of these

---

281 Spamann, *supra* note 274, at 4–6.

282 La Porta et al., *supra* note 265, at 1123.

283 *Id.* at 1129, 1132.

284 The only normative theory that La Porta et al. provide is with respect to the protection of shareholders, where higher protection correlates with more liquid capital markets. *See supra* Part III.A.

285 *See generally* Djankov, McLiesh & Shleifer, *supra* note 263.

286 *Id.* at *3 (citing Joseph Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981)).

287 *Id.* at *2 (citing Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992); Oliver Hart & John Moore, *A Theory of Debt Based on the Inalienability of Human Capital*, 109 Q. J. ECON. 841 (1994); Oliver Hart & John Moore, *Default and*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

two factors, the authors collected data on the existence of private and/or public credit bureaus in 129 countries from 1978 to 2003. In addition, the authors replicate the LLSV Creditors' Right Index for every country in the sample for the same time period, with minor improvements in the index's coding methodology.[288] The existence of credit bureaus reflects the availability of information in the economy for credit bureaus to collect credit-history information on borrowers and share it with other lenders. The LLSV Creditors' Right Index proxies the protection that bankruptcy laws afford to creditors and measures the ease with which they can force the repayment of their loans.

1. The Findings

The study confirms the presence of important institutional differences between common and civil law countries. These differences are resilient, persisting and not converging, throughout the twenty-five year period the paper investigates. Common law countries provide more protection to creditors than countries with French civil law heritage.[289] More generally, richer countries better protect creditors than poorer ones.[290] They also rely more heavily on private credit bureaus.[291] Higher creditor protection strongly and positively correlates with higher private credit to GDP. Similarly, the existence of credit bureaus, private or public, positively correlates with higher private credit to GDP. Private credit to GDP increases with the improvement in any one of these two factors, improvement in information or an improvement in creditor protection, but the relative importance of this increase is a function of the per-capita income of the country. In rich countries, protecting creditors is a stronger determinant of private credit, whereas in poorer countries, credit bureaus are more effective in shifting the credit supply forward.[292]

Renegotiation: A Dynamic Model of Debt, 113 Q. J. ECON. 1 (1998); Robert Townsend, *Optimal Contracts and Competitive Markets with Costly State Verification*, 21 J. ECON. THEORY 265 (1979)).

288 *Id.* at *6.

289 *Id.* at *12.

290 Djankov et al., *supra* note 263, at 13.

291 *Id.* at 13–14.

292 *Id.* at 16, 18–20.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

2. *Critique: Ambiguity and Under-Specification in the Definition of Variable*

The methodological limitations of this study are similar to those of La Porta et al.'s *Law and Finance.* These limitations have been extensively highlighted these limitations above. Indeed, one of Djankov's core indicators is the LLSV Creditors' Right Index. Here, Djankov resorts to local experts. However, this *alone* does not increase the accuracy of the LLSV Creditors' Right Index especially when under-specification and the problem of ambiguous variable definitions remain unchanged. Even worse, inconsistent coding exacerbates in the latter case for dispersed respondents could fill instruction gaps differently.[293] Specific questions, such as "is there an automatic stay on secured assets" hardly prompt accurate responses for the reasons explained above. Only detailed case study oriented questions can do this task satisfactorily. Finally, some of the improvements in the coding of the LLSV Creditors' Right Index that the authors explicitly explain appear to be additional mistakes rather than enhancements in the coding methodology. For example, the authors mention how they have recoded the LLSV Creditors' Right Index for India using the Sick Industrial Act ("SIA"), instead of the general Companies Act ("CA"), as the bankruptcy law of reference.[294] Yet the authors claim to study small and medium size enterprises that are most probably subject to the general CA and not the SIA.

C. *Collateral Law More Important Than Bankruptcy Law?*

Rainer Haselmann et al. argue that collateral law is more important than bankruptcy law in determining the levels of private credit to GDP. To the authors, creditors care more about the ease with which they can grab collateral outside bankruptcy rather than about their rights during bankruptcy where creditors compete among each others for fewer assets.[295]

1. *The Model and the Findings*

To test their argument, the authors collected data on banks' lending in twelve Central and Eastern European countries that have undergone major legislative reforms since 1991. They also constructed an improved "Creditors'

---

[293] Spamann, *supra* note274, at 5.

[294] Djankov et al., *supra* note 263, at 6.

[295] Rainer F.H. Haselmann, Katharina Pistor & Vikrant Vig, *How Law Affects Lending* (Columbia Law and Economics Working Paper No. 285, 2006), *available at* http://ssrn.com/abstract=846665.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Right" index that is the sum of two sub-indices. The first sub-index is the Collateral Law index. It investigates: (1) whether the law recognizes the validity of non-possessory charges on moveable assets; (2) whether the law provides for a registry to perfect these charges and to guarantee priority; and (3) whether it is possible to mortgage real estate and to record the mortgage in a local land or court registry. The second sub-index is the LLSV Creditors' Right Index but expanded to take into account the existence of automatic triggers that render the filing for bankruptcy mandatory after the advent of an event of default that is defined by law.[296] The results of this study corroborate earlier findings: an increase creditor protection is associated with higher lending volumes. The authors show, however, that collateral law is a better determinant of private credit than bankruptcy law: the Collateral Law Index correlates more significantly private credit to GDP than the Creditors' Rights Index.[297] Finally, the study reveals that foreign banks are more sensitive than domestic banks to creditors' rights reform. This is because incumbent banks, in comparison to new entrants, enjoy the benefit of a well established relation-based network that is less dependent on formal legal rights contrary to new entrants.[298]

2. *Critique: The LLSV Creditors' Right Index is Not a Bankruptcy Index*

Haselmann follows the same methodology that La Porta adopted in *Law and Finance*, especially with respect to creating legal indices on collateral and bankruptcy laws. Consequently, Haselmann's conclusions suffer from the same shortcomings and critiques that graft La Porta's results. More importantly, the authors interpret their results to mean that "[t]he introduction of a legal regime that enhances each lender's individual prospects of enforcing her claims (collateral law) results in greater increases in lending volume than changes in bankruptcy law, the essence of which is to provide an orderly liquidation or reorganization process in the presence of multiple creditors."[299] Behind this conclusion lays the wrong assumption that the LLSV Creditors' Right index is a proxy to bankruptcy law or, more specifically, to collective procedures. But rather the LLSV Creditors' Right index is a restrictive index that imperfectly measures the grab powers of secured creditors during bankruptcy. The LLSV Creditors' Right index inquires: (1) whether secured

[296] *Id.* at 16–17. The debtor is unable to pay its debts after they become due for more than 90 days.

[297] *Id.* at 24–25.

[298] *Id.* at 26.

[299] *Id.* at 1.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

creditors are stayed in reorganizations; (2) whether they get the absolute priority to proceeds of their collateral in liquidations; (3) whether management can file for reorganization unilaterally; and (4) whether if it does so, it keeps managing the debtor's assets. Few of these questions, if any, measure the collective characteristics of the bankruptcy statute, and specifically its ability to factor the interests of other stakeholders such as unsecured creditors and in-the-money equity holders. The ease with which creditors can take all kinds of assets as collateral to secure their loans, rather than the power they have to foreclose on the collateral upon financial distress, could be a better determinant of private credit. This however has no implications with respect to whether collateral law is a better determinant of private credit than bankruptcy law. Only an indicator that reflects the collective procedure as such could answer this question. *Debt Enforcement around the World* represents such an attempt.

D. Debt Enforcement Around the World

In *Debt Enforcement Around the World*, Simeon Djankov compares the performance of debt enforcement mechanisms in eighty-eight jurisdictions worldwide.[300] The authors aim to establish a reform agenda that addresses and solves the perceived inefficiencies of bankruptcy law.

1. The Model and the Findings

To measure the performance of bankruptcy statutes, the authors study the fate of a hypothetical insolvent firm, a single-asset hotel company called "Mirage."[301] Mirage was founded and owned, at fifty-one percent by Mr. Douglas with no other single shareholder owning more than five percent of its common stocks. Mirage has one secured creditor, Bizbank, which holds a mortgage on the hotel and a floating charge on all the company's assets, and whose loan represents seventy-four percent of the total value of Mirage's outstanding debt. Mirage has other unsecured creditors, including suppliers, the tax authority, and employees, whose aggregate claims represent the remaining twenty-six percent of Mirage's liabilities.[302] The authors assume two scenarios: Mirage's going concern value is superior to its liquidation value

[300] Simeon Djankov et al., *Debt Enforcement Around the World* (NBER Working Paper No. 12807, 2006), *available at* http://www.nber.org/papers/w12807.pdf.

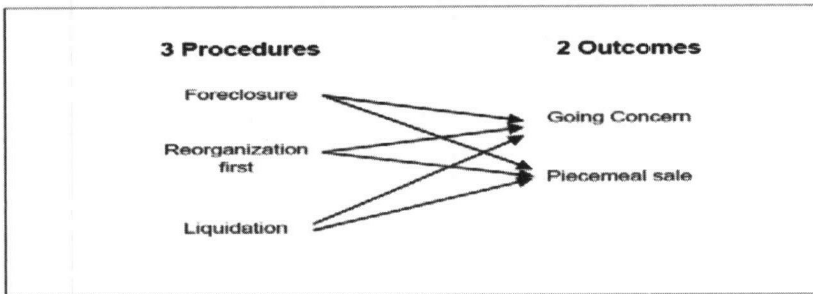
[301] The authors provide detailed assumptions with respect to the size the company, its capital as a percentage of the country's GDP, the number of employees it has, and its ownership structure. *See id.* at *9–10.

[302] *Id.* at *6.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

and vice-versa. For both scenarios, local bankruptcy experts predict the fate of Mirage based on the law as practiced in their respective jurisdiction: (a) Bizbank will foreclose on its collateral out-of-court; (b) Mirage will go into formal liquidation; or (c) Mirage will be judicially restructured. Based on the respondents' estimates the authors compute the time and cost of debt enforcement in a given jurisdiction and assess whether bankruptcy law channels the debtor toward an efficient outcome. Whatever is the legal route, foreclosure, liquidation, or reorganization, the efficient outcome ("EO") is reached under the first scenario if Mirage's operations are uninterrupted, and hence, if its going-concern value is preserved.[303]

Figure 5: Procedures and Outcomes[304]



The authors then calculate a measure for efficiency, the Efficiency Index, which they define as the present value of the terminal value[305] of the firm after bankruptcy costs:

$$E = (100*EO + 70*(1-EO) - 100*C) / (1+ r) ^ t$$

Where EO equals 1 if the efficient outcome is achieved and zero otherwise, C and t are the cost and time to go through insolvency, respectively, and r is the lending rate.[306] Moreover, the authors identify twenty-four structural characteristics of insolvency laws, and correlate each one of them with the estimated Efficiency Index (E). The authors control for legal origins, per-

---

303 *Id.* at 13.

304 *Id.*

305 "The value of an investment at the end of a period, taking into account a specified rate of interest." http://www.investopedia.com/terms/t/terminalvalue.asp.

306 Djankov, *Debt Enforcement*, *supra* note 301, at 19.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

capita income, the time and cost of the enforcement proceedings, and EO.[307] These correlations investigate which structural characteristic best determines Efficiency (E). Table 4 below lists the structural characteristics that the authors investigate.

[307] *Id.* at 26.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Table 4: Characteristics of the Insolvency System[308]

Statutory time limits on appeals	Equals 1 if there are time limits that restrict the duration of any appeal of the judgment by any party. Equals 0 otherwise. Procedure of relevance: all
Out of court seizure and sale	Equals 1 if the secured creditor may seize and sell its collateral without court approval, judgment or enforcement. Equals 0 if court approval, judgment or enforcement is required to enforce security. Procedure of relevance: foreclosure.
No judgment for enforcement	Equals 1 if the secured creditor my enforce its security either in an enforcement court or out of court procedure, without first obtaining a judgment authorizing it to do so. Equals 0 if a court judgment is required before proceeding to enforcement. Procedure of relevance: foreclosure.
Floating charge	Equals 1 if laws allow a secured creditor to take an entire business as collateral for a loan, including all present and future assets, tangible and intangible, and a changing pool of assets. Equals 0 if available security instruments restrict the secured creditor to taking only certain types of fixed assets as collateral—such as the land or the building—or otherwise do not allow the secured creditor to take the entire business as collateral. Procedure of relevance: foreclosure
Specialized court	Equals 1 where the authority with jurisdiction in the case of Mirage is either a specialized bankruptcy court or a specialized bankruptcy administrative authority, 0 otherwise. A specialized bankruptcy court would generally have jurisdiction over liquidation and reorganization, but not foreclosure/debt enforcement proceedings. Procedure of relevance: liquidation/reorganization.
Case proceeds on appeal of insolvency order	Equals 1 if the insolvency case is not automatically suspended upon appeal of the order initiating the insolvency process or if the insolvency order cannot be appealed at all. Equals 0 if the case is suspended until resolution of the appeal. Procedure of relevance: liquidation/reorganization.

308 *Id.* at Table 1.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Same judge for appeal of insolvency order	Equals 1 if an appeal of the initiation of the insolvency case is handled by the same judge supervising the insolvency case. Equals 0 if the appeal is heard by a different judge in an appeals court. Procedure of relevance: liquidation/reorganization.
case proceeds on appeal of liquidation sale	Equals 1 if a sale in liquidation is executed even on appeal of the liquidation order or if the liquidation order cannot be appealed at all. Equals 0 if the case is suspended until the resolution of the appeal. Procedure of relevance: liquidation.
Same judge for appeal of liquidation sale	Equals 1 if an appeal of the order to liquidate Mirage is handled by the same judge supervising the insolvency case. Equals 0 if the appeal is heard by a different judge in an appeals court. Procedure of relevance: liquidation.
Case proceeds on claim amount dispute	Equals 1 if the insolvency case is not automatically suspended when a creditor disputes a claim amount or if the claim amount cannot be appealed at all. Equals 0 if the case is suspended until resolution of the appeal. Procedure of relevance: liquidation/reorganization.
Same judge for claim amount dispute	Equals 1 if an appeal of the amount of the claim is handled by the same judge supervising the insolvency case. Equals 0 if the appeal is heard by a different judge in an appeals court. Procedure of relevance: liquidation/reorganization.
Reorganization attempt required	Equals 1 if by law Mirage must first attempt reorganization before proceeding to liquidation. Equals 0 if it is possible for Mirage to enter liquidation first. Procedure of relevance: liquidation/reorganization.
Automatic stay on enforcement	Equals 1 if the secured creditor may not enforce its security against Mirage upon commencement of the insolvency proceedings, 0 otherwise. Procedure of relevance: liquidation/reorganization.
Automatic stay on lawsuits	Equals 1 if lawsuits against Mirage are automatically stayed upon commencement of the insolvency proceedings, 0 otherwise.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Firm must cease operating	Equals 1 if Mirage must cease operations upon commencement or during the insolvency proceedings, 0 otherwise. Procedure of relevance: liquidation/reorganization.
Contracts may be rescinded	Equals 1 if suppliers and customers may rescind contracts with Mirage without penalty upon the initiation of insolvency proceedings, 0 otherwise. Procedure of relevance: liquidation/reorganization.
Restrictions on dismissals	Equals 1 if Mirage is restricted from dismissing employees upon the initiation of insolvency proceedings, 0 otherwise. Procedure of relevance: liquidation/reorganization.
Management remain	Equals 1 if management remain in control of decisions in the ordinary course of business during the resolution of the insolvency proceeding. Equals 0 if management is automatically dismissed or must be supervised or seek approval from the insolvency administrator or court for decisions in the ordinary course of business. Procedure of relevance: liquidation/reorganization.
Creditor approves administrator	Equals 1 if the secured creditor may appoint or must approve the appointment of the insolvency administrator. Equals 0 if only the court, the debtor and/or other participants appoint the administrator. Procedure of relevance: liquidation/reorganization.
Creditor dismisses administrator	Equals 1 if the secured creditor may dismiss or must approve the dismissal of the insolvency administrator. Equals 0 if only the court, the debtor and/or other participants appoint the administrator. Procedure of relevance: liquidation/reorganization.
Administrator paid on market value	Equals 1 if the insolvency administrator is remunerated on the basis of the market value of the insolvency estate. Equals 0 if the insolvency administrator is remunerated on the basis of the book value of assets or on a daily rate. Procedure of relevance: liquidation/reorganization.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Automatic trigger for liquidation	Equals 1 if an "automatic trigger" mechanism can initiate insolvency. An automatic trigger is defined as a set of circumstances—such as on the period of default or ratio of assets to liabilities—under which Mirage must by law apply for insolvency proceedings. Procedure of relevance: liquidation/reorganization.
Proof of reorganization prospects required	Equals 1 if Mirage must submit proof of reorganization prospects before reorganization proceedings may commence. Equals 0 if Mirage may commence reorganization proceedings without evidence that the procedure may be successful. Procedure of relevance: reorganization.
Creditors vote directly	Equals 1 if secured creditors vote directly on the reorganization plan. Equals 0 if secured creditors vote in committee or not at all. Procedure of relevance: reorganization.

The authors find a systematic difference between rich and poor countries with the former being much more efficient in enforcing debt and in handling complex legal procedures.[309] In poorer countries, reorganizations fail most of the time and creditors are better off in simple out-of-court foreclosures. Controlling for per-capita income, legal heritage also determines the Efficiency Index, with French civil law countries marking the lowest and Scandinavian and common law countries marking the highest scores.[310] Foreclosures perform efficiently if the law allows "floating charges," where the entire business is pledged as collateral to the secured creditor, but perform poorly otherwise.[311] Similarly, rules that mandate suspending the debtor's operations, allowing excessive appeals, or permitting creditors to rescind their contracts upon insolvency, reduce efficiency. Finally, the authors find that the Efficiency Index significantly and positively correlates private credit to GDP. It does not correlate, however, with the LLSV Creditors' Right index or with measures on the availability of information on borrowers. To the authors, "[d]ebt enforcement looks a lot like other measures of the quality of government"[312] for it highly correlates with various other proxies of public

[309] *Id.* at 4.
[310] Djankov et al., *supra* note 301, at 5.
[311] *Id.* at 5–6.
[312] *Id.* at 7.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

enforcement and public sector performance, such as tax compliance, legal formalism, corruption, and infrastructure quality.[313]

2. Critique: The Paper is Not Normative and Fails to Give Guidance for Reforming Collective Procedures

By resorting to elaborate case studies and local experts, the Efficiency Index avoids most of the shortcomings that graft the LLSV Creditors' Right Index. Its importance, however, is limited to observing and reporting interesting discrepancies in the efficiency of bankruptcy proceedings worldwide, especially between rich and poorer countries, without providing normative guidance for effectively reforming bankruptcy laws.

$$E = (100*EO + 70*(1\text{-}EO) - 100*C) / (1+ r) \wedge t$$

Indeed, the Efficiency index argues for low costs (C) and speedy bankruptcy proceedings (t) that preserve the going concern value of the failing company (EO) but fails to state how to do so. For example, the authors report that foreclosures perform efficiently in countries that allow floating charges. One reason why this might be true is the paper's restrictive assumptions whereby one secured creditor holds seventy-four percent of its debtors' total liabilities and holds a mortgage and a floating charge on all the assets of its debtor. To the authors, the senior secured creditor has, as a residual owner, the right incentives to maximize the value of its debtor. However, this is true only if the secured creditor is the sole residual owner, such as when the optimal value of the debtor equals exactly the value of the secured creditor's loan. In all other and more common situations, however, the senior secured creditor's incentives are to sell the debtor at any price that guarantees it full recovery irrespective of the interests of other stakeholders. Moreover, conflicts of interest are exacerbated when more than one secured creditor holds a floating lien on all or part of the debtors' assets. At best, such procedure is not collective but is centered, again, on La Porta's grab theory. The experience of England with administrative receivership in this respect is telling. The arguments that follow were advanced by the proponents of the Enterprise Act of 2002 and strongly contradict Djankov's recommendations:

- Administrative receivership puts too much power in the hands of one creditor, namely the floating chargeholder. This may lead to unnecessary business failure and undermine corporate rescue, as the

313 *Id.* at 5–7.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

floating chargeholder has no need to take into account the interests of any other creditors nor those of the company.

- There is a lack of transparency and accountability, as the floating chargeholder takes decisions which have a significant impact on the returns to other creditors without their consent. Furthermore, there is no equivalent of the duty owed by an administrator to act in the interest of creditors as a whole.
- The absence of an incentive to obtain greater realizations once the secure debtors are assured that their claims will be met from the asset realizations may lead to early sales with low values. It may also prohibit the continued operation of the business as a going concern.
- With the growth of asset based lending, factoring and discounting, there is an increasing diversity of parties holding security. This means that corporate rescue is more difficult to effect, as parties may have conflicting interests and some may be more inclined to appointing earlier to realize their security and not stand in line behind other parties. It is also more difficult to rely on self regulatory measures introduced by secured creditors, such as the Bank Statement of Principles.[314]

The fact that the *descriptive* Efficiency Index correlates private credit to GDP is also of limited normative value for such correlation reflects an established economic principle where efficient debt enforcement positively affects the supply of credit. The normative inquiry is to identify what structural characteristics of bankruptcy statutes determine efficient debt enforcement outcomes. The authors fail to approach this query comprehensively or to provide a general theory for guiding bankruptcy reform. Instead, the authors fall back the same limitations that graft the LLSV Creditors' Right Index. Instead of relying on case studies, the authors resort to conceptual questions that are under-specified and ambiguously defined. This opens the door to inconsistent and subjective coding. Local experts, under these circumstances, exacerbate coding inaccuracies for now each respondent fills the gap differently. For example, the study inquires whether "contracts may be rescinded."[315] The indicator "[e]quals 1 if suppliers and customers may rescind contracts with Mirage without penalty upon the initiation of insolvency proceedings [and] zero otherwise."[316] Bankruptcy experts know

---

[314] Vernon Dennis and Alexander Fox, The New Law of Insolvency: The Insolvency Act 1986 to Enterprise Act 2002 10 (The Law Society 2003).

[315] Djankov et al., *supra* note 301, at Table 1.

[316] *Id.*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

that such a question cannot be answered without further information. What is meant by insolvency? Is it liquidation or reorganization? What is meant by suppliers? Is it the landlord or the supplier of goods? What is meant by rescinding the contract? Does the contract have an ipso facto clause or an automatic cancellation clause for default? Did the debtor default before filing or after filing for "insolvency?" Without explaining the rationale that stands behind each of these questions, one can immediately see that the answer can change dramatically depending on the respondent's assumptions.

More importantly, even if answered by a conscientious local expert, the question fails to distinguish the law on the books from the law as practiced. For example, a Japanese lawyer who strictly follows the study's instructions would answer the question of whether contracts are rescinded in "insolvency" negatively. However, while avoiding ipso facto clauses, Japan allows cancellation clauses that are linked to the debtor's defaulting on his contractual obligations.[317] Since many debtors default before filing for bankruptcy, contracts in practice, can be rescinded during financial distress and skillful lawyers usually draft contracts to maximize their client's ability to rescind a contract at will.[318] Most, if not all, other conceptual indicators with respect to the characteristics of structural bankruptcy law face similar shortcomings.

Moreover, the Efficiency Index divides the sample into three sub-indices: (1) countries where foreclosure was the debt enforcement procedure of choice; (2) countries where liquidation was chosen; and (3) countries were Mirage was reorganized. The number of observations used as structural indicators in the regressions testing varied as a function of the indicator's relevance to the debt enforcement procedure of choice. This is much less than the eighty-eight original countries that are part of this study and inexorably exacerbates the degree of freedom problem that all cross-country studies face.

Finally, the authors also fail to find statistically significant correlations between the Efficiency Index and most structural indicators of bankruptcy, except for "rescinding contracts," "freezing debtor's operations in liquidation," and "excessive appeals," all of which decrease efficiency. Does this mean that all other bankruptcy rules, such as preference avoidance, fraudulent conveyance, the powers of the trustee as a lien creditor, and debtor-in-

---

[317] *See* Michihiro Mori, *Japan finalizes insolvency law reform, available at* http://www.iflr.com/?Page=17&ISS=21187&SID=606164.

[318] *See, e.g.*, LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT A SYSTEMS APPROACH 218 (Aspen 2003).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

possession financing are irrelevant and do not determine efficiency and the outcomes of the bankruptcy system? In fact, the authors' approach in determining what structural characteristics of bankruptcy law determine efficiency is incomplete for it fails to investigate essential bankruptcy features. More importantly, the authors' method is simplistic. By taking every structural indicator on its own, and by testing its explanatory powers in single and independent regressions where the Efficiency Index is the dependent variable, the authors wrongly disaggregate core bankruptcy concepts that typically cannot function efficiently unless taken as a whole in a single and comprehensive bankruptcy statute. This is because bankruptcy law is a balancing exercise, where every pro-debtor right that aims to preserve the going-concern value of the failing company opens the door to the abuse of creditors' pre-bankruptcy entitlements. This is especially true when these pro-debtor rights are not adequately balanced with equivalent pro-creditor rights that limit the debtor's opportunity to forum shop without completely negating the debtor's benefit to reorganize. Hence, it is by studying the collective procedure as a whole that a researcher can provide general and normative policy recommendations in order to reform debt enforcement mechanisms. A Bankruptcy Indicator of normative value should pass this *comprehensibility* test.

IV. ONE SIZE FITS ALL? THE LEGAL ORIGIN DEBATE

A recurring finding in all the studies discussed in Part III relates to the important role that legal heritage plays as a determinant of financial development. This section will review the possible avenues through which legal heritage and other institutional differences influence financial progress. Such influence and avenues are important to uncover for they affect what bankruptcy rules are best fitted for jurisdictions that share similar institutions. To some, common law is superior to civil law because it gives judges more independence and is more adaptable to economic changes. Others, however, believe that both systems are substantively similar and equal. The discrepancies in financial development are caused by other factors, such as: the natural "endowment" of former colonies, which, in turn, determined the nature of the institutions that the settlers chose to establish; the effects of transplanting laws without adjusting them to the culture and the needs of indigenous people; the resistance of vested interests; and the politics and ideologies of social democracies. If legal origin were a major determinant of financial development, it would also greatly but indirectly shape bankruptcy

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

policy. Optimal bankruptcy rules could be a function of the institutional characteristics of jurisdictions. Certain bankruptcy arrangements could yield efficient results in country X but less efficient outcomes in country Y because of their interaction with various legal and economic variables that this section uncovers. This section discusses the implications of accepting any one of these explanations regarding the debate on bankruptcy policy and the development literature. Legal origin theories are fatalistic. They presume that countries can hardly improve their legal system and economic performance without renouncing important institutional characteristics. Theories that do not subscribe to legal origin explanations open the door for multiple optimums where different institutions could equally promote financial development and economic growth. When testing the effect of bankruptcy laws on various efficiency indicators, cross-country empirical studies should control for deeply rooted societal and cultural choices in order to distinguish and to assess their impact on financial development and optimal bankruptcy policies.

A. Common Law Superior to Civil Law

To Hayek, legal traditions differ on two major fronts. First, they diverge on to what extent the judiciary is independent from the government. This determines how much private property is protected against the risk of expropriation by the state, which in turn determines certainty and financial activity.[319] Second, legal traditions differ in their capacity to adapt, such as their ability to accommodate new contractual agreements in order to finance new forms of economic transactions.[320] The listing requirements that the New York and London Stock Exchanges have adopted since the nineteenth century exemplify the decentralized character of common law, which encourages self-regulation initiatives. These initiatives can influence market needs by creating the right environment for market forces to thrive.

1. The Judicial Independence Channel

To Hayek, differences across legal traditions with respect to judicial independence are an accident of history. Common law and French civil law derive from Roman law and local practices, and share substantive similarities.

[319] Studies show that firms retain their earnings to further their investments in countries where property rights are protected and invest less in countries where these rights are weakly enforced. *See, e.g.*, Simon Johnson, John McMillan & Christopher Woodruff, *Property Rights and Finance*, 92 AM. ECON. REV. 1335 (2002).

[320] *See generally* FRIEDRICH A. HAYEK, THE CONSTITUTION OF LIBERTY (Univ. of Chi. Press 1960).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Starting from the seventeenth century, however, the history of England and France diverged dramatically causing the appearance of important ideological rifts between their legal systems. In England, landowners forced their way out of the feudal system over centuries and ultimately gained their independence from the King. Since landowners also served on common-law courts, they naturally protected property rights against the arbitrary powers of the state. Later, common law judges sided with Parliament against the Crown in an open conflict that led Parliament to victory. Judges were rewarded with tenure, prestige, and good salaries. Common law became strongly associated with economic freedom and property rights protection.[321]

France, however, faced the opposite experience. In Bourbon's era, the *parlements* were the country's legislative, judicial, and administrative authorities. Membership in this selective organization was inherited or bought by the nobility. *Parlements'* members were part of the King's court and enjoyed the benefit of power and money. In return for these privileges, the *parlements* protected the Crown and enforced its monopolistic and elitist system. Until the French Revolution, courts were considered villains whose influence should be checked. In order to avoid "government by judges,"[322] the French Revolution disbanded the *parlements* and barred the judiciary from reviewing executive acts. This resulted in weaker courts that do not have enough authority to oppose the state.[323] In sum, to Hayek, the difference between civil and common law can be traced to the concept of liberty and the institutions this concept induces. Common law is aligned with John Locke and David Hume's conception of liberty as the individual freedom to pursue individual ends. On the other hand, civil law follows the Hobbes and Rousseau emphasis on government's freedom to pursue the collective good.[324]

2. The Adaptability Channel

The adaptability channel relates to how law is made under civil and common law. To Richard Posner, the common law is more efficient because its judges have a greater degree of autonomy and can adapt the jurisprudence case-by-case to continuously changing and unforeseeable circumstances by

---

[321] Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might Be Right*, 30 J. OF LEGAL STUD. 503, 508–09 (2001).

[322] *Id.* at 510 (citing JOHN HENRY MERRYMAN, THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA 28–29 (Stan. Univ. Press 1985).

[323] *Id.* at 509–11.

[324] *Id.* at 511 (citing HAYEK, *supra* note 320, at 54–70).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

following efficiency criteria.[325] Even if other judges follow different criteria than those that are based on efficiency, evolution toward efficiency persists:

> The eccentricities of judges balance one another. One judge looks at problems from the point of view of history, another from that of philosophy, another from that of social utility, one is a formalist, another a latitudinarian, one is timorous of change, another dissatisfied with the present; out of the attrition of diverse minds there is beaten something which has a constancy and uniformity and average value greater than its component elements.[326]

Paul Rubin believes it is the disputants, not the judges, who drive common law toward efficiency.[327] Parties resort more to court settlements when applicable rules are inefficient.[328] Because inefficient rules are more likely to be challenged in court, the probability that they will be reversed is higher than that of less litigated, more resilient, or more efficient rules.[329] To Rubin, common law's efficiency is "due to an evolutionary mechanism whose direction proceeds from the utility maximizing decision of disputants rather than from the wisdom of judges."[330] In comparison, French civil law eliminates jurisprudence as a source of law and establishes rigid procedural rules that relegate judges to purely administrative roles. By giving the legislator exclusive powers to make law, French civil law lost the ability it once had to adapt to changing and unforeseeable circumstances.[331] Professor

---

[325] RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW (Aspen 2003) (1973). *But see* Nicola Gennaioli & Andrei Shleifer, *The Evolution of Precedent* (NBER Working Paper No. 11265, 2005), *available at* http://www.nber.org/papers/w11265.pdf (finding that the diversity of judicial views might be beneficial under distinguishing but not under overruling).

[326] BENJAMIN N. CARDOZO, THE NATURE OF THE JUDICIAL PROCESS 177 (Yale Univ. Press 1921).

[327] Paul H. Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 51, 51 (1977); *see also* Martin J. Baily & Paul H. Rubin, *A Positive Theory of Legal Change*, 14 INT'L REV. L. & ECON. 467 (1994).

[328] Rubin, *supra* note 327, at 51 (citing William M. Landes, *An Economic Analysis of the Courts*, 14 J. L. & ECON. 61 (1971); John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973)).

[329] *See also* George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65, 65 (1977) ("It will be shown that efficient rules will be more likely to endure as controlling precedents regardless of the attitudes of individual judges toward efficiency, the ability of judges to distinguish efficient from inefficient outcomes, or the interest or uninterest of litigants in the allocative effects of the rules.").

[330] Rubin, *supra* note 327, at 51.

[331] Gino Gorla & Luigi Moccia, *A Revisiting of the Comparison between Continental Law and English Law (XVI–XIX Century)*, 2 J. LEGAL HIST. 143, 147 (1981) ("[T]he '*jurisprudentia forensis*,' progressing in a cumulative way through lawyers' interpretation and judicial opinions (especially those judges sitting in the Supreme Court of the Various states on the Continent), and resulting in a continuous literary legal tradition, was the principal source of law, a far more important one than any other in that same period. Indeed, the internal unification of the legal system of each state was achieved, just as in England, also on the Continent,

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Merryman believes that French judges were successful in circumventing these rigidities over time, but that judges in transplant colonies were not.[332]

3. *A Case Study: Common Law's Flexibility, Self-Regulation and Liquid Capital Market*

A good historical example of how flexibility can prompt superior economic performance is the rise of the New York and London Stock Exchanges in the late nineteenth and early twentieth centuries. During this period, American investors were inadequately protected and minority shareholders' rights were typically abused. Judges, and even the legislators, were easily bribed and companies resorted to regulatory arbitrage in order to avoid minimal anti-fraud regulation.[333] During the same period, French and German laws did not provide less protection to investors. Nonetheless, liquid capital markets emerged in the U.S. and England but not in France and Germany. John Coffee believes that self-regulation is the key to understanding this phenomenon.[334] The New York and London[335] stock exchanges established stringent listing regulations that enhanced the transparency and integrity of the market. Underwriters had representatives on the board of directors of firms they sponsored in order to guarantee the promotion of their investors' interests and preserve their reputation in a competitive environment. To the contrary, the Paris Bourse, another government agency with monopoly over stock trading, had members who were civil servants with no real incentive to promote the exchange's transparency and competitive standing. Similarly, Germany encouraged the creation of large private banks and hindered the development of liquid exchanges by adopting penalizing tax rules on securities.[336] Large banks with sufficient capital endowment were able to fund investors' needs for

---

albeit here some centuries later, mostly by means of judicial precedents handed down in the higher courts of justice.").

[332] *See generally* John H. Merryman, *The French Deviation*, 44 AM. J. COMP. L. 109 (1996).

[333] *See, e.g.*, Edward B. Rock, *Encountering the Scarlet Woman of Wall Street: Speculative Comments at the End of the Century*, 2 THEORETICAL INQ. L. 237 (2001).

[334] *See generally* John C. Coffee, *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001)

[335] *See* Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459 (2001) (showing that separation of ownership and control can precede not follow a highly specific set of laws governing companies if "alternative institutional structures" exist to perform the function of such laws).

[336] Coffee, *supra* note 335, at 7–8. *See, e.g.*, Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan and the United States*, 102 YALE L. J. 1927 (1993).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

capital without the need to resort to the stock market.[337] Coffee believes that legislative rules follow, rather than precede, market needs. Influential private parties, like stock exchanges, can influence market needs by creating the right environment for market forces to thrive. In this respect, common law's advantage is its decentralized character which encourages self-regulatory initiatives, whereas in civil law systems the state monopolizes all law-making initiatives.[338]

4. *Which Channel is More Important?*

In two empirical studies of thirty-eight jurisdictions worldwide, Thorsten Beck et al. investigated whether the political or the adaptability channel better determined financial development.[339] The authors used information on the tenure of Supreme Court justices and the extent to which the Supreme Court was competent to hear cases that involved the government's actions to measure the political independence of the judiciary in the researched countries.[340] Similarly, the authors used information on the importance of precedent as a source of law, the role of equity, and judicial formalism, in order to measure the adaptability of the legal system in the relevant jurisdictions.[341] The authors measured financial developments by using indices at the aggregate and firm levels.[342] At the aggregate level, the authors collected information on banks and stock market development.[343] The information included: (1) private credit to GDP, which measures the amount of savings that are channeled to entrepreneurs via financial institutions;[344] (2) the total value of equity shares relative to GDP, which measures the development of the stock market relative to the economy's size;[345] and (3) the LLSV Creditors' Right Index that proxies the degree of property rights protection.[346] At the firm level, the authors assessed the difficulties that companies face to raise external capital. The data

---

[337] Coffee, *supra* note 335, at 8.

[338] *Id.* at 9.

[339] Thorsten Beck et al., *Law and Finance: Why Does Legal Origin Matter?*, 31 J. COMP. ECON. 653 (2003); Thorsten Beck et al., *Law and Firms' Access to Finance*, 7 AM. L. & ECON. REV. 211 (2005).

[340] Beck, *Why Does Legal*, 31 J. COMP. ECON. at

[341] The authors use raw data from Simeon Djankov et al., *The Regulation of Entry*, 117 Q. J. ECON. 1 (2002) in order to construct the adaptability indexes with minor changes to the original methodology. Beck et al., *Access to Finance*, *supra* note 340, at 214.

[342] Beck et. al., *Access to Finance*, *supra* note 340, at 214.

[343] *Id.*

[344] The data is for the period going from 1990 to 1995. *Id.*

[345] The average is measured over the same period: 1990 to 1995. *Id.*

[346] *Id.*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

come from the World Business Environment Survey, which was conducted in 1999, and covers more than 4,000 firms across the researched jurisdictions.[347] The survey provides information with respect to: (1) the obstacles that firms report and that hinders their ability to get external finance; (2) the role of collateral in impeding firms' financing needs; (3) the role of bureaucracy and paper work in hindering firms' ability to access credit; and (4) the accessibility of long-term loans.[348] For both aggregate and firm measures, the authors find that the adaptability channel is a better determinant of financial development than the political independence channel.[349]

B. Are There Other Factors That Better Explain Financial Development?

Some have rejected the idea that common law is inherently more efficient than civil law. Robert Cooter and Lewis Kornhauser, for example, defend an "impossibility theorem;" a theory which says that a legal system that evolves randomly cannot improve continuously.[350] Efficient and inefficient rules will recur regularly and perpetually. The legal system is never optimal under these conditions. Konrad Zweigert and Heinz Kotz note the extreme resistance that common law has displayed against giving parties that are not explicit parties to a contract a right to sue on it.[351] The authors contrast common law rigidity in this respect with the flexibility that civil law countries have shown by granting greater leeway to third parties via legislative reform.[352]

Other scholars believe that the differences between civil and common law have been exaggerated and note the progressive convergence of both legal systems.[353] For example, civil and common law judges adopt a similar approach with respect to precedent.[354] Civil law courts rarely overturn their

---

[347] *Id.*

[348] *Id.*

[349] *Id.*

[350] Robert Cooter & Lewis Kornhauser, *Can Litigation Improve the Law without the Help of Judges?*, 9 J. LEGAL STUD. 139 (1980).

[351] KONRAD ZWEIGERT & HEIN KOTZ, AN INTRODUCTION TO COMPARATIVE LAW, 468 (Tony Weir trans., Clarendon Press 3d. Ed. 1998) (1977)).

[352] *Id.*

[353] Katja Funken, *"The Best of Both Worlds"—The Trend Towards Convergence of the Civil Law and the Common System* (LA732 Comparative Legal Essay, 2003)), available at http://www.jurawelt.com/sunrise/media/mediafiles/13598/convergence.pdf.

[354] A. Peczenik The Binding Force of Precedents, in: Interpreting Precedents: A Comparative Study 461, N.D. MacCormick, R.S. Summers eds., 1997.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

own decisions in order to preserve the court's authority,[355] whereas in common law countries, the rigid concept of *stare decisis* has begun to fade.[356] Similarly, judicial activism is not exclusive to common law judges. Civil courts can also "make" the law and have done so historically.[357] The German Supreme Court's rulings in the "revalorization cases" during Germany's post-World War I super-inflation is a good example in this respect.[358] Furthermore, the adoption of a lengthy bankruptcy code, securities regulations, and tax codes in the U.S., England, Canada, and Australia, among others, reflects a strong trend toward codification in common law countries.[359] Major codification ventures, such as Karl N. Llewellyn's Uniform Commercial Code, find their source of inspiration in civil law concepts.[360] Today, the interpretation of statutes, in the "age of statutes,"[361] is at least as important as interpreting case law in U.S. lawsuits.[362] The increasing influence of American law worldwide,[363] the unification of Europe and the harmonization process that it entails,[364] and various harmonization efforts at the level of international organizations, such as the Hague Conference on Private International Law, the International

---

[355] Over a period of more than fifty years, "the German Federal Constitutional Court . . . departed from its precedents in fewer than a dozen cases." Funken, *supra* note 354, at 10–11. Some countries such as Germany and Spain made the decision of their constitutional courts binding on lower jurisdictions. In other countries, such as France, judges rarely contradict the opinion of the "Cour de Cassation" in fear of seeing many of their decisions overruled and their career staled. *Id.* In common law countries, on the other hand, the rigid concept of Stare Decisis is in retreat. *Id*

[356] The United States Supreme Court distanced itself from the doctrine in Erie Railroad Co. v. Tompkins, 304 U.S. 64 (1937), overruling Swift v. Tyson, 41 U.S. 1 (1842). The British House of Lords abandoned the doctrine in its strict aspect in 1966. *See Practice Statement (Judicial Precedent)*, 3 All ER 77 (1966) (L. R. Ch.).

[357] Funken, *supra* note 354, at 13.

[358] *Id.* at 14. Katja Funken cites also Article 1 of the Swiss Civil Code that expressly orders judges to decide "cases not covered by statutory provisions or customary law according to the rule the judge establish as a legislator." *Id.*

[359] UGO MATTEI, COMPARATIVE LAW AND ECONOMICS 101–21 (University of Michigan Press 1997).

[360] RUDOLF B. SCHLESINGER, ET AL., COMPARATIVE LAW, CASES, TEXT, MATERIALS 16–17 (Foundation Press 5th ed. 1988).

[361] *See generally* GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES (Harvard University Press, 1985).

[362] William N. Eskridge, Jr. & Phillip P. Frikney, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321 (1990); Shael Herman, *The Fate and the Future of Codification in America*, 40 AM. J. LEGAL HIST. 407 (1996).

[363] The American influence has grown, especially with respect to securities regulations, commercial rules, and other contractual forms that investors use in business transactions such as factoring, franchising and leasing. Joachim Zekoll, *The Louisiana Private Law System: The Best of Both Worlds*, 10 TUL. EUR. & CIV. L.F. 1 (1995).

[364] European Directives are transplanting civil law concepts in English common Law. On the other hand, the European Human Rights Commission and Court and the European Court of Justice are slowly but surely shaping the laws of member countries into an emerging European Common Law.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Institute for the Unification of Private Law (UNIDROIT) and the United Nation Commission on International Trade Law (UNCITRAL), further contribute to the erosion of clear cut conceptual differences among legal systems worldwide.

Without completely rejecting the role of legal origins as a determinant of financial development, scholars have put forward theories that they claim better explain discrepancies in financial development across countries.

1. Endowment Theory

Acemoglu emphasizes geography and diseases in former colonies, rather than legal tradition, as determinants of institutional development.[365] In former colonies, institutions were built by European colonizers to fit their colonization aims. In countries where Europeans aimed to settle, such as the United States and Australia, the settlers created institutions that mirrored the ones they had at home and that enhanced the growth and viability of their new colonies. Such institutions protected property rights. In colonies where Europeans aimed only to extract wealth and ship it back home without plans to settle, they built "extractive" institutions that did not protect property rights but empowered some, the elite, at the expense of others. Congo, the Ivory Coast, and much of Latin America are examples of such "extractive states."[366] Europeans adopted either settlement or extraction strategies depending on how hospitable a colony's geography and disease environment were. In colonies where diseases were widespread and deadly, settlement was not feasible and Europeans built extractive institutions instead. On the other hand, in colonies that were adequately endowed, for example with suitable geography and low mortality rates related to diseases, Europeans settled and built institutions that supported such an aim.[367] These institutions endured and were inherited by the former

[365] Daron Acemoglu et al., *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 AM. ECON. REV. 1369 (2001).

[366] *Id.* at 1370.

[367] *Id.* Seventy-two percent of Europeans died during the first year of settlement in Sierra Leone. In Gambia and Niger, all Europeans died before reaching their destination. Acemoglu explains how European newspapers disclosed the mortality rates in colonies in order to inform potential settlers on colonies' endowments. Citation. This explains the settlers' preference for the American colonies and not Guyana where mortality was high. *Id.* at 1373–74 (citing PHILIP D. CURTIN, THE IMAGE OF AFRICA (1964); PHILIP D. CURTIN, DISEASE AND EMPIRE: THE HEALTH OF EUROPEAN TROOPS IN THE CONQUEST OF AFRICA (1998)).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

colonies.[368] The identity of the colonizer, and the legal tradition it carried with it, was hence less relevant.[369]

What came to be known as the "endowment" theory helps explain the observed differences in financial development across countries. In extractive states, governments tend to be non-democratic and the financial development of the extracting elite is threatened by democracy or a growing and open economy. Settlement colonies, however, tend to be democratic and protective of property rights causing financial development to thrive. Thorsten Beck et al. conducted a cross-country study of seventy former colonies in order to test empirically the validity of the endowment theory and whether it cancelled or attenuated the effects of legal tradition as a determinant of financial development.[370] The authors used aggregate data on financial intermediaries, the market for equities, and the protection of property rights as measures of financial development.[371] They used Acemoglu et al.'s measures on the mortality rates of settlers upon the arrival of Europeans to the former colonies as a proxy for each colony's original endowment. For additional checks, the authors used the absolute value of the latitude of each country as an alternative endowment measurement. The authors also controlled for alternative determinants of financial development, including data on ethnic diversity, religion, independence year, and a continent dummy.[372] They found that both endowment and legal traditions determined financial development; however, endowment better explains the cross-country variations in the development of financial intermediaries, such as private credit relative to GDP, and equity markets development, such as the size of market equity capitalization relative to GDP.[373]

2. *The Transplant Effect*

In an empirical study of forty-nine jurisdictions worldwide, Berkowitz et al. argue that the way the law was "transplanted" in the recipient country is a better determinant of the performance of the legal institutions (legality) than

---

[368] *Id.* at 1376.
[369] *Id.* at 1372–73.
[370] Thorsten Beck, et al., *Law, Endowments, and Finance*, 70 J. FIN. ECON. 137 (2003).
[371] *See id.* at 141.
[372] *Id.*
[373] *Id.* at 153–62.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

the legal family of the transplanted law itself.[374] The authors distinguish countries that have created their laws and regulations internally (origin countries) from those that have received their laws from outside their boarders (transplant countries). To Berkowitz et al., an efficient law is one that is in demand, for this ensures its implementation. This is true when a country willingly imports a law of whatever legal origin and adapts it to the needs of its economy and the values of its population. Because these on-the-books laws are in demand, the public will ask for efficient institutions that can enforce them effectively. In such countries, "the legal order [. . .] function[s] just as effectively as in an origin country". To the contrary, in countries where laws were imposed by force or have not been adapted to local needs, popular demand for their implementation is weak. These countries are hence subject to what the authors call the "transplant effect;" their legal order will function less optimally than countries that have developed or adapted their laws internally.[375]

Their paper's statistics show that the "transplant effect" is a better determinant of legality than is legal heritage. Controlling for legal origins, countries with transplant effect obtain 33% lower legality scores than countries with no such effect. The transplant effect is resilient across all levels of national income. Moreover, the transplant effect determines economic development, although indirectly, through its effect on legality.[376]

3. *Incumbents and Resistance to Financial Development*

Paul Rubin, on the other hand, stresses the importance of interest groups as a driving force that could push the legal system either toward an efficient or inefficient outcome.[377] The superiority of one system over another, common law versus statutory law, hinges on the forces that are shaping public choices at any particular time. Nineteenth century common law is associated with efficiency because at that time there were independent forces, primarily individuals, who favored particular rules. Since 1930, when statutory law became the norm, special interest groups were able to form and gain prominence. These groups, Rubin argues, were not necessarily driven by efficiency considerations but lobbied for legislation or litigated for common

---

[374] Daniel Berkowitz, et al., *Economic Development, Legality, and the Transplant Effect*, 47 EUR. ECON. REV. 165 (2003).
[375] *Id.* at 166–67.
[376] *Id.* at 183–86.
[377] Paul H. Rubin, *Common Law and Statute Law*, 11 J. LEGAL STUD. 205 (1982).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

law rules that furthered the group's regulatory agenda. Rubin believes that "the inefficiency effects of the formation of these groups have probably outweighed their effects leading toward efficiency, but this is not necessarily true for all time."[378] More importantly, statutory law could be more efficient if forces that are biased toward efficiency become more assertive.

Raghuram Rajan and Luigi Zingales explore the role of incumbents as a shaping force of public choices throughout history.[379] The authors collected data on financial development in twenty-four countries from 1913 to 1999 with respect to: (1) the evolution of the ratio of deposits to GDP; (2) the evolution of stock market capitalization over GDP; (3) the evolution of the fraction of gross fixed capital formation raised through equity; and (4) the evolution of the number of listed companies per million people.[380] They found that countries were relatively more financially developed in 1913 than in 1980, and only recently have countries started reaching and exceeding their 1913 development levels. More importantly, the authors noted that countries with a common law legal tradition did not fare better than their civil law counterparts in 1913. In fact, at the start of the twentieth century, the equity market in civil law Germany was more liquid than its British counterpart.[381] Yet, if legal tradition was the major determinant of financial development, such differences should have been perceived during the early stages of institutional choices. If La Porta et al. were correct, common law countries should have outperformed civil law countries since 1913. The authors proposed a political theory to explain the observed discrepancies in financial development. They argue that developed and liquid financial markets open the door to competition, which in turn threatens the dominant position of incumbent firms. Interest groups representing entrenched interests would, therefore, oppose financial development in order to preserve their monopolistic privileges. The influence of these groups, however, is weakest in economies that are open to both trade and capital flow. The authors argue that exporters and other pro-trade groups gain more wealth, and hence, more influence and power over those who only rely on entrenched controls. This makes pro-trade groups more successful in pressuring for change over time.[382]

---

[378] *Id.* at 222.

[379] Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003).

[380] *Id.* at 10–12.

[381] *Id.* at 12–17.

[382] *Id.* at 17–21.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Rajam and Zingales argue that openness to trade and capital mobility is largely exogenous to a country's internal politics. Some countries have no other option but to engage in trade due to their small size or their geographical attributes, such as being surrounded by countries which are also open to trade. The authors use a country's distance from its trading partners as an exogenous proxy of its trade openness. Since capital flow is more mobile, the authors argue that "the strategic complementarities in cross-border capital flows are likely to be stronger."[383] This allowed them to collect information with respect to world-wide cross-border capital flows over time, and use it as an exogenous proxy of countries' openness to capital mobility. The authors note high capital mobility both at the beginning of the twentieth century and, more recently, toward the end of the century with low mobility between 1930 and 1970. This last period corresponds to the "reversal" period when countries became relatively less financially developed. These findings corroborate the authors' claim that the combination of openness to trade and capital flow mutes incumbent influences that oppose financial development.[384]

4. Social Democracies' Anti-Market Ideology

Professor Mark Roe presents an alternative political theory to explain the discrepancies in the development of financial markets across countries.[385] To Roe, liquid financial markets with diffuse equity give rise to important agency costs. The law curbs these costs by requiring managers to maximize shareholders' value. This duty is important because the unrestrained incentives of managers oppose the incentives of residual owners and are aligned with those of employees, for example, salary increase, risk aversion, and empire building. Social democracies protect property rights but emphasize redistribution for the benefit of poorer employees and at the expense of capital. This exacerbates agency costs because dispersed capital owners lack tools similar to the shareholders' maximization criterion to check managerial powers. To monitor management, shareholders keep equity ownership concentrated. This explains the persistence of family ownership of listed companies in social democracies such as France, Germany, and Italy. Politics,

---

[383] *Id.* at 8.

[384] *Id.* at 33–36; *see also* Marco Pagano & Paolo Volpin, *The Political Economy of Finance*, 17 OXFORD REV. ECON. POL'Y 502 (2001).

[385] *See generally* MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (2003).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

social democracies versus liberal democracies, not legal traditions determines financial development.[386]

C. Legal Origins, Financial Development, and Bankruptcy Policy

If legal origin was a major determinant of financial development, it would also greatly, but indirectly, shape bankruptcy policy. Indeed, optimal bankruptcy rules would be a function of the institutional characteristics of jurisdictions. Certain bankruptcy arrangements would yield efficient results in country X but less efficient outcomes in country Y due to their interaction with various legal and economic variables that this section uncovers. This could lead to the existence of multiple bankruptcy rules that are equally optimal. A major idiosyncratic variable that policymakers should take into account is the availability of information in a particular economy. This poses the question of investors' reaction to known rules. Do different bankruptcy rules induce creditors to adopt different lending strategies in order to mitigate the law's shortcomings? This section discusses the implications of accepting, or not accepting, the legal origin factor in the debate on bankruptcy policy and development literature.

1. Multiple Optima

In a study of thirty-five jurisdictions worldwide, Stijn Claessens and Leora F. Klapper collected data from government and private sources in order to document the number of commercial bankruptcy filings from 1990 to 1999.[387] They found important variations in the frequency of judicial bankruptcies across jurisdictions. Their paper highlights the role of financial markets in affecting optimal bankruptcy practices. In common law market-oriented systems, where debtors typically face dispersed bondholders, creditors benefit from resorting to formal bankruptcies. This allows for the coordination of disorganized, redundant, and, potentially conflicting claimholders' actions. Here, rules that address the collective action problem, such as the automatic

[386] Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539 (2000).

[387] Stijn Claessens & Leora F. Klapper, *Bankruptcy Around the World: Explanations of its Relative Use* (World Bank, Working Paper No. 28625, 2003), *available at* http://ssrn.com/abstract=405240. In order to compare the number of bankruptcy filings within the country sample, the authors divide the number of bankruptcy filings by the corresponding number of firms as provided by Simeon Djankov, et al, *The Regulation of Entry*, 117 Q. J. ECON. 1 (2005), and official country statistical handbooks. Claeseens & Klapper, *supra* note at 389, at 11.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

stay, are most useful. On the other hand, debtors in civil law bank-oriented economies are typically closely associated with one dominant bank lender.[388] There, the benefits of formal bankruptcy are greatly attenuated.[389]

The characteristics of the debt market determine not only whether investors in fact resort to judicial bankruptcy but they also shape the substance of bankruptcy rules. To John Armour et al., concentrated debtors face limited monitoring and coordination costs.[390] Hence, a manager-displacing bankruptcy system is optimal because it gives creditors more leverage over managers who face the prospect of losing their jobs in the event of bankruptcy. The displacement of managers will not necessarily precipitate the debtor into an inefficient liquidation because creditors can cheaply cooperate amongst themselves to save the going-concern value of the failing company. In contrast, a manager-friendly bankruptcy system is inefficient because it undermines creditors' powers and monitoring ability. The opposite holds in economies where markets are liquid and bondholders are dispersed. There, manager-displacing bankruptcies can be disastrous because creditors face high monitoring and coordination costs. Old management is needed in order to lead the restructuring effort and to avoid the premature liquidation of the debtor.[391]

2. The Crucial Role of Information

The analysis above highlights the crucial role of information in shaping which bankruptcy rules are optimal. To investigate the costs of financial distress associated with asymmetric information, Takeo Hoshi et al. collected data from the Nikkei Financial Data Tape on 125 Japanese manufacturing companies that were listed on the Tokyo Stock Exchange from April 1978 to March 1985.[392] Typically, Japanese firms have ties to a main bank and are part of a larger industrial structure known as the keiretsu. With cross-share

---

388 This is so via the bank's participation in the debtor's equity or by placing the bank's representatives on the debtor's board of directors.

389 Claessens & Klapper, *supra* note at 389, at 10 (showing that firms in East Asia with a bank as their controlling shareholder are less likely to use bankruptcy as a means of resolving financial distress).

390 John Armour, et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699 (2002). This paper builds on an earlier paper: David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325 (1998). In its original version, this theory associated manager-driven bankruptcy regimes with dispersed share ownership and manager-displacing regimes with concentrated ownership patterns.

391 *Id.* at 1703, 1762–72.

392 Takeo Hoshi, et al., *The Role of Banks in Reducing the Costs of Financial Distress in Japan*, 27 J. FIN. ECON. 67 (1990).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

ownership, bank representatives on the board of directors, and strong product market ties among suppliers and customers, the Japanese firm can effectively avoid the cost of asymmetric information during financial distress. By comparing these firms to others that have no ties to a main bank or are not members of a keiretsu, the authors isolated and analyzed the cost of asymmetric information in bankruptcy. The authors reported superior recoveries for group-firms, or firms that have a main lender bank, relative to those that are not part of a group or have no main bank lender. Specifically, group or main-bank firms invest more and sell more than non-group or non-main bank firms in the year following financial distress. These findings corroborate the earlier analysis with respect to the important relationship that exists between information asymmetries, the characteristics of the market for credit, and bankruptcy policy.[393] By determining financial development—i.e. the supply of credit, bondholders' dispersion, and the depth and liquidity of the debt market—legal origins shape optimal bankruptcy choices.

3. Investors' Reaction to Known Rules

Stijn Claessens and Leora F. Klapper show how bankruptcy rules create incentives with outcomes that are hard to predict and assess beforehand. For example, if secured creditors are not stayed in bankruptcy, they have enough bargaining power to recover more in out-of-court settlements. On the other hand, such a rule does not adequately prevent a creditors' run on the debtor and its disorderly liquidation, which typically results in lowering creditors' recovery. Similarly, strictly enforcing the APR stems the debtor's propensities to take uncalculated risks. Under the APR, however, the debtor would excessively postpone filing for bankruptcy because such a rule does not give the debtor a stake in reorganizing his own business. This, in turn, could lower creditor recovery rates.[394]

Similarly, the authors argue that whether bankruptcy rules prove optimal is a function of the efficiency of the judicial system. Creditors often encourage efficient tribunals to enforce their rights. Debtors react by taking fewer risks, which results in fewer bankruptcies. If courts are inefficient, the cost of judicial intervention exceeds its benefits and creditors prefer to settle their disputes out-of-court. Here, debtors' propensity to take risks increases and

393 *Id.* at 68–69.

394 Claessens & Klapper, *Bankruptcy Around the World*, *supra* note 387 at 6–7.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

bankruptcies become more numerous.[395] The law could address the system's weak enforcement mechanism by allowing secured creditors to foreclose on their collateral in bankruptcy to increase their bargaining power and to increase their chances of reaching a favorable out-of-court settlement. If the enforcement system functions well, however, creditors are better off when the law imposes upon bankruptcy a general automatic stay to preserve the going-concern value of the debtor and to avoid its premature disintegration.[396]

Sergei Davydenko and Julian Franks studied a sample of 2,280 small to medium firms that defaulted on their loans from ten banks in France, Germany and the United Kingdom. The study found that differences in the bankruptcy code and creditors' rights across countries induce banks to adopt different lending strategies with respect to their debtors.[397] In particular, the study shows how French banks mitigate unfriendly creditor rules by over-securing their loans, relative to banks in other countries, and by only taking collateral that can resist statutory dilution.[398] The authors found comparatively lower median recovery rates in France, fifty-six percent compared to ninety-two percent for the United Kingdom and sixty-seven perent for Germany, despite these adjustments. In out-of-court settlements, however, the authors found no major differences among the three countries in the recovery rates of banks.[399] Interestingly, the authors reported that debtors face similar costs for capital[400] in the three studied countries notwithstanding the better creditors' protection and recovery prospects of English banks. The authors explained this anomaly by noting that the banking industry in both France and Germany is more competitive than the one in the United Kingdom which translates into English banks having more discretion to determine the price of money.[401]

---

395 For example, in a study of East-Asian countries, Claessens find that creditors are more likely to incur the costs of formal bankruptcy if their rights and the efficiency of the judiciary make their recovery rate worth the cost. Stijn Claessens et al., *Resolution of Corporate Distress in East Asia*, 10 J. EMPIRICAL FIN. 199 (2003).

396 Classens, *supra* note 389, at 8–9.

397 Sergei A. Davydenko & Julian R. Franks, *Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK* (European Corporate Governance Institute, Finance Working Paper No. 89/2005, 2006), *available at* http://ssrn.com/abstract=647861.

398 For example, French lenders prefer accounts receivable over real estate collateral, which is more popular among lenders in the U.K. and Germany. Real estate proceeds are diluted by preferential creditors such as employees' wages and procedural expenses. *Id.* at 2.

399 *Id.*

400 The costs of capital are the interest rate spreads that are charged by banks.

401 *Id.* at 3.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The discussion above stresses the importance of controlling for other legal and economic factors when conducting cross-country empirical studies on bankruptcy laws. Most importantly, the efficiency of the judiciary, the level of information available in the country, the size and growth of the economy, and the inflation rate, are all factors that can determine which bankruptcy rules are optimal in a particular jurisdiction.

4. *Implications: Fatalism and One Size Fits All vs. Functional Equivalence and Multiple Optima*

Legal origin theories are fatalistic. Such theories would imply that countries with an "inefficient" legal tradition can hardly improve their economies without renouncing their legal heritage. Law and finance scholars, such as La Porta and Djankov, advocate a "one size fits all" approach to legal reform.[402] The remedies that are necessary for economic efficiency are universal. They are portrayed in the efficiency indictors that law and finance scholars build in to their various studies.[403]

Other theories either reject or de-emphasize the role of legal origins as a determinant of financial development. To various degrees, these theories provide for the possibility of functional equivalence between equally efficient legal systems. Efficiency could be achieved via various routes for which legal indicators cannot always account. For example, it is the openness to trade and free movement of capital, both functions of geography and the political clout of vested interests that determine financial development. Furthermore, if there are institutions providing a minimum threshold of contract enforcement, Roe's political theory argues that every economy has adopted optimal rules in function of the socio-political environment prevailing in such economy at a given time. What is efficient in a common law country might be less efficient and could even lead to a backlash in a civil law country with difference societal preferences. Finally, the transplant theory rejects the one size fits all approach. One size fits all is in fact the source of the problem: the "transplant effect." Efficiency requires the adaptation of transplanted laws to the idiosyncratic traditions of each nation.

---

[402] THE INT'L BANK FOR RECONSTR. & DEV., THE WORLD BANK, DOING BUSINESS IN 2004: UNDERSTANDING REGULATION xvi (2004).

[403] *Id.*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

CONCLUSION: AGENDA FOR FURTHER RESEARCH

The above literature reviews what is known and what is not known in bankruptcy policy. Devising an efficient bankruptcy statute is more imperative than promoting a regime that allows contractual bankruptcy. The impracticalities and costs of formulating an effective contractual bankruptcy model have already been highlighted. More importantly, even scholars who support freedom of contract in bankruptcy agree that legislatures should adopt a default statute to lower transaction costs in case investors find it cheaper to resort to judicial bankruptcy. Hence, scholars should make it a priority to further investigate this avenue.

Cross-country empirical studies are by far the most insightful studies in this context. Minor statutory reforms are possible based on the observed shortcomings of bankruptcy law in a particular country. Typically, however, legislatures are reluctant to make fundamental changes in bankruptcy rules without empirical data that test *ex ante* their efficiency outcome. However, such data cannot exist until the changes are implemented. Drastic bankruptcy reform becomes an adventurous enterprise that could bring good or catastrophic consequences. Worldwide, countries have adopted various bankruptcy rules reflecting different policies and value choices. By studying the effects of these policy choices on targeted financial indicators while controlling for other idiosyncratic characteristics of the jurisdictions, scholars can test various bankruptcy models before committing to a particular one.

This exercise should assess the law as practiced rather than the law on the books in order to yield accurate data and superior conclusions. Hypothetical case studies analyzed by local experts provide the best results in this context. Case studies avoid under-specified conceptual questions that are ambiguously defined and increase the objectivity and transparency of the coding process. Moreover, case studies capture functionally equivalent concepts that are equally efficient but that are missed in standardized conceptual surveys.

The laws to assess are of course bankruptcy laws, where bankruptcy is defined as a *collective* procedure. As a collective procedure, bankruptcy law is an all encompassing pot where the interests of *all* bankruptcy stakeholders - secured creditors, unsecured creditors of any kind, and equity-holders - are factored in, interact, and are organized in a process that comprehensibly and efficiently addressed financial distress. A Bankruptcy Indicator of normative value should pass this *comprehensibility* test. It is not a collateral law indicator

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

or an indicator that measures exclusively the grab powers of secured creditors, nor is it individual provisions of a bankruptcy statute, taken one by one independently and correlated to other financial indicators of efficiency. What is it?

Finally, the research should decisively address questions that have been heavily debated in the literature but not definitively answered: Is auction bankruptcy superior to bargaining? Are deviations from absolute priority efficient? And to what extent should the law sacrifice creditors' pre-bankruptcy contractual entitlements to preserve the debtor's going concern value?

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.